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TAX·FEATURES

Uncle Sam's IOU Tops $2 Trillion— $8,600 for Each U.S. Man, Woman, Child

The Federal deficit may drop—how much is uncertain—according to most projections coming out of Washington. But Tax Foundation analysts shows no prospect for reducing either the Federal debt or the interest payments on that fiscal millstone.

The legal debt ceiling of $1,824 trillion will be breached by the end of October 1985. To pay the government's bills, Congress will have to raise the debt limit above the $2 trillion level for the first time in history. This milestone comes at the close of a fiscal year that witnessed the largest deficit ever recorded—$211 billion. Fiscal 1985 also saw the most costly annual interest bill in U.S. history—nearly $130 billion—according to economists at the Tax Foundation.

The legal debt ceiling has a history that is almost boring in its relentless upward climb. From 1947 through February 1958 the statutory debt limitation remained at $275 billion. Since then Congress has raised the limit nearly every year. Taxes debt of the U.S. government passed the $500 billion mark in 1975, and doubled, to top the $1 trillion level for the first time, in 1982. The debt will double again by 1986.

For every man, woman, and child in the nation, the debt will reach $8,600 by the end of 1986, an increase of nearly $900 in a single year, according to analysts at the Washington-based tax watchdog organization.

The debt grows because the American people are receiving government benefits—but passing on the costs of these goodies to future generations. More importantly, the debt is growing because interest charges on the debt are growing and the principal is not being repaid. In other words, more and more of the debt is caused by debt. And the process seems locked in an inescapable spiral.

Net interest payments exceeded $100 billion annually in 1984 and 1985. That equals more than 60 percent of the annual deficits. In fiscal year 1986, about 80 percent of what the government borrows will go to pay interest on previously accumulated debt. Interest costs in 1986 are estimated at $138 billion. They will account for 14 percent of total budget outlays—up from 9 percent six years ago.

Since 1980 interest has been the fastest growing segment of the Federal budget. Net interest payments have shot up at an average annual rate of nearly 20 percent. (Net interest represents interest paid by the government less interest received on debt held by Federal agencies and accounts.) In comparison, non-interest outlays have risen by less than 9 percent a year and receipts at slightly over 7 percent annually. The debt itself has grown at a 15 percent annual rate.

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Mark Your Calendar

The 37th Annual Conference of the Tax Foundation will take place **Wednesday, December 4, 1985**, at the **Waldorf-Astoria Hotel** in New York City. The day-long conference, titled "The Tax Agenda—Level Field or Minefield?", will feature speakers from the business community and government officials. Sessions will include discussion of business tax policy, the business transfer tax, and the budget and trade deficits.

The 48th Annual Dinner and presentation of Tax Foundation's 1985 Distinguished Public Service Award will follow that evening.

Complete details and reservation forms for the 1985 Conference and Dinner are already in the mail.

Federal Deficits, Debt Outstanding, and Related Measures

Selected Fiscal Years 1975-1986[a]
(Billions)

Year	Receipts	Outlays[b]	Deficit[b]	Gross Federal debt[c]	Net interest
1975	279.1	332.2	53.2	544.1	23.2
1976	298.1	371.8	73.7	631.9	26.7
1977	355.6	409.2	53.6	709.1	29.9
1978	399.7	458.7	59.2	780.4	35.4
1979	463.3	503.5	40.2	833.8	42.6
1980	517.1	590.9	73.8	914.3	52.5
1981	599.3	678.2	78.9	1,003.9	68.7
1982	617.8	745.7	127.9	1,147.0	85.0
1983	600.6	808.4	207.8	1,381.9	89.8
1984	666.5	851.8	185.4	1,576.7	111.1
1985	730.0	947.3	211.3	1,844.3	129.6
1986	779.8	957.7	177.8	2,076.9	138.1

[a] Data for 1985 and 1986 are based on current-services estimates presented by the Administration in August 1985.
[b] Includes activities of off-budget agencies, to which receipts are attributable to these transactions.
[c] End of fiscal year.
Source: Office of Management and Budget, Department of Commerce, and Tax Foundation computations.

Taxes Grow 7.5% as Tax Index Surges to 513.9; Federal and State-Local Levies Outpace GNP

The Tax Index rose to 513.9 (1967 = 100) in the first half of 1985, as the nation's tax bill climbed to more than five times the level recorded in the base year 1967, according to Tax Foundation economists. The Federal Index stood at 496.0, and the State-Local Index at 551.1.

The Index reflected tax receipts of Federal, state, and local governments totaling $1,127 trillion, an increase of $79 billion or 7.5 percent, as compared to the first half of 1984. Federal taxes were up by 7.8 percent over the year and state-local taxes by 7.0 percent.

At the same time, gross national product (GNP) for the first half of this year came to an Index level of 479.3 (1967 = 100), lagging behind tax growth with a 6.5 percent increase from a year before.

The Tax Index is a fiscal yardstick designed by Tax Foundation economists to provide a continuing current measure of tax trends on a basis comparable to indexes for other segments of the economy.

Among the different taxes represented in the overall Index, the highest-growth component since the base year is social insurance taxes, with an index of 773.9 for the first half of 1985. Personal income taxes follow, at an index of 567.6; then indirect business taxes at 440.4.

Corporate profits show a high cumulative growth Index of 725.3 at state and local levels for the first half of 1985, whereas the Federal Index for this revenue source was on the low side—223.1, slightly more than twice the base year amount. State-local corporate income taxes in 1985 to date have been equal to nearly 27 percent of their Federal counterpart, up from 8 percent in the 1967 base year.

Personal income taxes at state and local levels have also risen much more rapidly than Federal income taxes. At an index of 1,076.0 in the first half of 1985, the state-local personal income tax is the first index component to show a ten-fold growth rate. The Federal income tax Index was 517.6 for the first half of the year. The differential between Index levels for federal and state-local income taxes is also reflected in the rise of subnational income taxes from 10 percent of Federal taxes in 1967 to 53 percent in 1985.

Social insurance contributions have risen most rapidly at the Federal level, reaching an Index of 791.6; but the state-local Index for social insurance taxes also has been a fast-growing component, coming to 679.2 for the first half of 1985.

Indirect business taxes—which include property taxes on both business and residential properties, as well as sales, excises, and customs levies—have risen more rapidly at state and local levels (478.3) than at the Federal level (310.4).

While all types of taxes combined were 7.5 percent higher in the first half of 1985 than a year earlier, individual income taxes were up by 10.5 percent; social insurance taxes by 10.2 percent; indirect business taxes, 7.0 percent; and miscellaneous taxes, 5.6 percent. Corporate profits taxes were lower than a year ago, at 9.9 percent.

Between first and second quarters this year, the Index actually dropped by 9.7 percent (from 521.7 to 506.1), reflecting an extraordinary $44.6 billion (annual rate) drop in Federal personal income tax collections. This unusual twist owes to the slowdown that IRS experienced in getting tax refunds mailed to the many filers due them this year. Over $20 billion in refunds that ordinarily would have offset first-quarter receipts was chalked up against second quarter receipts instead. This temporary drop, however, has no significance as an economic signal, to smooth over the changes due to IRS refunding practices, Tax Foundation analysts have combined the first two quarters into a single tax index for the first half of 1985.

Tax Index by Level of Government and Type of Tax, and Major Economic Indices
Selected Periods 1960-1985[a]
Index Numbers, 1967 = 100

Type of Tax	1960	1970	1980	1983	1984	1985[b]
All governments						
All taxes	61.4	133.2	361.2	441.1	484.6	513.9
Personal income	56.0	141.5	413.4	491.9	527.3	567.6
Corporate profits	69.8	105.2	263.0	233.8	276.6	263.7
Indirect business taxes[c]	63.4	133.7	294.9	396.4	419.4	440.4
Social insurance contributions	48.7	151.0	474.4	651.3	712.7	773.9
All other[d]	61.4	123.1	228.0	240.4	249.3	269.5
Federal government						
All taxes	64.0	127.5	351.0	424.2	460.1	496.0
Personal income	60.0	140.4	389.6	448.8	479.8	517.6
Corporate profits	71.4	102.0	214.2	190.1	213.8	223.1
Indirect business taxes[c]	36.0	119.6	223.2	296.8	314.1	310.4
Social insurance contributions	48.7	154.3	479.7	644.3	706.3	791.6
All other[d]	71.2	135.3	211.4	197.5	197.5	210.4
State and local governments						
All taxes[e]	57.0	142.1	369.9	476.4	524.1	551.1
Personal income	49.3	142.6	437.3	535.2	575.1	616.0
Corporate profits	67.0	111.3	309.3	280.4	341.1	325.1
Indirect business taxes[c]	89.4	150.7	371.8	512.5	538.8	478.3
Social insurance contributions	48.6	136.9	447.1	666.1	720.1	679.2
All other[d]	56.2	126.0	240.6	284.9	300.1	317.6
Exhibit:						
GNP (current prices)	60.1	134.1	356.1	411.8	448.1	479.4
GNP (constant prices)	83.0	103.7	114.8	113.1	119.1	124.8
Implicit price deflator for GNP	80.0	133.1	277.7	323.4	338.0	290.7

[a] Most taxes are shown on an accrual basis.
[b] First half at seasonally adjusted annual rate.
[c] Includes sales, excise, and customs levies and all property taxes (including those on business and residential property).
[d] Estate and gift taxes and miscellaneous taxes.
[e] State and local property taxes.
Source: Tax Foundation computations and estimates based on data from U.S. Department of Commerce, Bureau of Economic Analysis.

Tax Features

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FEDERAL TAX POLICY MEMO

Editor: Edward A. Sprague, Vice President–Tax and Economic Affairs

OCTOBER 1985

Battle Over State/Local Tax Deductions

There is growing opposition to the Reagan tax reform proposal to eliminate the personal deduction for state/local taxes. This proposal is particularly important to the overall reform plan because it would provide over 40 percent of all the individual base-broadening measures (in dollar volume) or $40 to $46 billion by fiscal 1990. If the provision is dropped or severely curtailed, the opportunity for reducing marginal rates obviously would be restricted, too, or some large new alternative revenue source would have to be developed. Needless to say, the latter would be extremely difficult.

While the Administration maintained a no-compromise position on removing the state/local tax deduction through the Spring and after releasing the Reagan I program, there is lots of talk in Congress of accommodating the critics of the proposal. Suggestions range from limiting the deduction by a dollar cap to retaining it for some state/local taxes and not others. Unfortunately, most of the compromises being talked about do not make for sound tax policy.

In this regard it is important to note the traditional justification for deductibility—that state/local taxes reduce income involuntarily and thus reduce ability to pay. This rationale was part of the original income tax structure going back to the Civil War. The deduction as a subsidy to taxpayers in high-tax states was a non-argument.

Over the years certain tax reformers have attacked the state/local tax deduction for eroding the progression of the income tax—it being of most value to upper-income taxpayers. Followers of the Haig-Simons school claim that state/local taxes are really payments for "consumer services"—schools, fire and police protection, local roads, etc.—of benefit to the taxpayer and, therefore, should not be excluded from a comprehensive income tax base. If so, however, these are "services" over which individual taxpayers have very limited choice. ***Unless you happen to live at a marina in a state with no income tax, with a food/drug exemption from sales tax and acquire your other goods from an out-of-state mail-order house, you are going to pay state/local taxes whether or not you enjoy their "services."***

In the Treasury I reform plan of November 1984, the theme of state/local taxes as consumer payments was picked up again, but in a most unconvincing manner. Since then, justifying the elimination of the deduction has relied almost totally on the charge that the present deduction subsidizes taxpayers in high-tax state/localities relative to low tax areas. In this writer's opinion, at least, nobody has come forth to date with a compelling case that state/local tax payments—which can amount to a very significant portion of a family budget—do not reduce ability to pay Federal income tax. One can argue, of course, that the objective of lower marginal rates is overriding—that the deduction should be foregone because of the economic and other benefits of rate reduction. But particularly if rate reduction is to be compromised by retaining some deductibility of state/local taxes, it behooves the policymakers to pay close attention to the method chosen.

Threat of Double Taxation

One recurring proposal is to change the state/local deduction into a credit which could be set at a level low enough to minimize revenue loss and at the same time continue some benefit for middle-income taxpayers. A simple dollar cap on the amount of deduction that could be taken would serve the same objective. But in either case the result would be a haphazard increase in the progression of the tax structure. And depending on the extent of the credit or remaining deduction, there would be less opportunity for offsetting rate relief.

Question must be raised as to whether this is an appropriate way to change the distribution of tax burdens. ***It is not at all unusual for an upper-income resident in New York State to have state/local tax liabilities in excess of $10,000 annually. Perhaps one needn't feel too sorry about the circumstances of such taxpayers. But the fact remains that while they may have a degree of control over the level of their property and sales taxes, they have virtually no choice with respect to New York's hefty personal income tax—even heftier, of course, for New York City residents.*** To indicate to such taxpayers, as did the November 1984 Treasury report, that they could exercise a lower tax choice by moving to another state is hardly a viable option for most individuals tied to jobs and other circumstances. Their net income available for other purposes certainly is reduced by such payments, and eliminating or severely curtailing the Federal deduction could well be construed as a form of double taxation. From a policy viewpoint, to impose a *selective* double taxation on top of this, according to income, makes matters worse. The greater the "contribution" to state/local public services the higher the Federal tax penalty would be.

Congress, of course, could choose another route and allow deductibility of state/local taxes only *above* a certain level—say one or two percent of gross income as proposed initially for charitable contributions. This would answer in part the above objection but then would accentuate the difference in treatment between high-tax and low-tax states. It would give relatively more advantage to taxpayers in high-tax states—the very problem that the Administration program seeks to correct.

Yet another tack Congress could take is to retain deductibility for income and property taxes while eliminating it for sales taxes as was proposed in the draft program of the Carter Administration in 1977. Or perhaps retain deductibility of

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income taxes only. This type of program would have less impact on the distribution of tax burdens and would minimize the double tax question. It also would be a powerful club over state/local tax policy and initiative. It would direct the states away from sales taxes by Federal edict. And that doesn't seem to accord with either the new or old Federalism.

A Straight Percentage Best

Probably the purest form of compromise that Congress could make in this area would be to allow a straight percentage of the existing deduction regardless of income or type of tax. This would be the least disturbing of tax policy measures. It would have a neutral effect on tax burden distribution, at least on those continuing to itemize. The percentage could be set at whatever level Congress determines to reconcile the base-broadening revenue need with the political objections of state/localities. But just because it seems logical on this score, don't bet on it or any other particular measure that could evolve from this Fall's turbulent markup of tax reform legislation.

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High Income Tax Burdens—II

The Tax Foundation's June/July *Tax Features* carried an article on high-income tax burdens indicating the very small number and proportion of those with incomes over $200,000 who managed to avoid any Federal income tax liability. The article was based on the latest available data from the IRS Statistics of Income (SOI) covering the calendar year 1982.

In the meantime, at the request of Representative Jake Pickle (D-TX), Chairman of the House Ways and Means Oversight Subcommittee, the Treasury Department has released a special study of 1983 high-income tax returns (over $250,000 in income) using a different definition of income and highlighting the role of partnership losses in reducing tax liability. The headline in Congressman Pickle's news story on the study read: "30,000 wealthy Americans paid little or no tax."

That makes quite a contrast with the only 298 individuals with expanded income[1] of $250,000 or more reported to pay no Federal income tax in 1982, according to the earlier data. Congressman Pickle was quick to point out, of course, how the latest data should be taken into account in the current tax reform consideration and especially called for a "strong and effective minimum tax provision that would require all wealthy taxpayers to pay a certain amount of tax." ***Tax reform should take aim at provisions which permit minimal effective tax rates among the wealthy. But a "strong" minimum tax may not be the answer.***

Stretching the Figures

There is something a little suspect about creating a new statistical measure in the midst of a highly charged political debate over the matters being measured. To prove your point you order up a new batch of figures. But apart from that, there are a couple of obvious explanations for the much higher numbers on tax avoidance.

First, including those who pay relatively minor amounts of tax—less than 5 percent of income—along with non payers in the same pot greatly expands the principal target group. Secondly, the definition of income used—total positive income (TPI)—is far, far broader than either adjusted gross income or expanded income. Basically, TPI is gross income for tax returns before losses. It includes positive income items from 1040 returns which, in the Treasury's words, "essentially equal the sum of (1) wages and salaries, (2) interest, (3) dividends, and (4) income from profitable business and investments." For capital gains it counts long-term and short-term gains before the 60 percent exclusion and *before* any losses. It includes rents, royalties and partnership income with gain excluding net losses.

The rationale for TPI is to account for the above-the-line offsets to income—especially partnership losses but also IRA and Keogh contributions, etc.—that reduce adjusted gross income and expanded income measures but still represent, in the Treasury's view, "economic" income. Treasury admits that TPI will not reflect some real economic losses but claims that most of the reported current losses are a result of partnership investment activities which typically show accounting losses for tax purposes but not actual economic loss.

The case for not reflecting capital gains losses seems much weaker. In this area the chances of real economic loss are certainly greater. High-income returns very often involve extensive capital gains transactions and the extent to which real capital losses are not reflected in TPI obviously overstate income and make the effective rates of tax look smaller. ***Some changes in the coverage of TPI could make a significant difference in the reported rate of tax, just as relatively small changes in the definition of "tax expenditures" can dramatically alter both the level and distribution of the tax expenditure budget.***

If we accept Treasury's TPI as a reasonable measure of income, there are a considerable number of high-income returns over $250,000 paying a lesser effective rate of tax than the average for upper-middle-income returns. But the *overall* pattern of tax burden distribution apparently would not change significantly from that based on adjusted gross income or expanded income. The effective rate of tax for the high-income group as a whole is still significantly above that for upper-middle-income returns. (Other income groups were not taken into account in the Treasury study.) Those 29,800 returns in the high-income group paying tax less than

[1]Expanded income equals adjusted gross income plus items of tax "preference"—mainly the excluded 60 percent of long-term capital gains—less investment expense.

five percent of TPI still are only 11 percent of the total high-income returns.

Effective Rate of Federal Income Tax on Total Positive Income, 1983

Returns with TPI of $250,000 or more	29.2%
with tax under 5% of TPI	1.7%
with tax over 20% of TPI	30.6%
Returns with TPI $40,000-$75,000	17.7%

Source: Unpublished Statistics of Income data, Office of Tax Analysis, Dept. of the Treasury.

Scalpel Better Than Blunderbuss

Tax policy, of course, should not be comfortable with almost 30,000 high-income returns paying 1.7 percent of income even if that measure of income is suspect. A legislative urge to do something about it is understandable. A stiffer minimum tax could help ensure higher effective rates. But as developed in detail in the May 1985* Federal Tax Policy Memo *the minimum tax is a blunderbuss weapon and can have untoward economic effects.

One "strong" minimum tax measure (H.R. 2424) has been proposed by Representatives Schumer (D-NY) and Russo (D-Ill.). An analysis by Arthur Andersen & Co. indicates the Schumer-Russo minimum tax, which, among other items, would include vested benefits of pension plans in the alternative base, could result in a *more than tripling* of taxes on an upper-middle-income taxpayer even if such taxpayer received no additional disposable income. (See Washington Tax Letter, June 28, 1985, Arthur Andersen & Co.) The extensive combination of preference income items in such a minimum tax base and an unfortunate timing of events could subject many taxpayers in virtually all income groups to sudden, sharp increases in tax liabilities whether or not they indulged in tax-motivated partnerships or other sheltered investments.

Contrary to some current sentiment, the high-income tax avoidance issue could be diffused substantially without resort to the complexities of the minimum tax. The Treasury data do indicate the extent to which tax-motivated shelter investments are responsible for reducing tax liability of high-income tax returns. For those returns over $250,000 paying less than five percent of TPI in tax, 67 percent of such income was offset by current business losses—mainly partnership losses. Below-the-line itemized deductions and credits accounted for only 19 percent of offset to such income.

The President's tax reform program contains specific provisions to reduce the attractiveness of such shelters by limiting allowable interest deductions and extending at-risk limitations. There are other proposals in Congress to make the rules even tougher on tax-motivated shelters. And, in fact, these proposals already are having an impact. The sales of leveraged real estate programs through shelter-oriented partnerships are down in dollar volume this year and comprise a significantly smaller share of overall real estate investment programs.

The scalpel is preferable to the blunderbuss.

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VAT After All?

Value added taxation is alive and kicking in the U.S. Congress seems to be noticing much less of all the attention to grandiose tax reform schemes but we may be chugging down the road toward a broad-based consumption tax at the federal level which could have the same impact as a consumption-based value added tax.

Yes, the same 15 percent tax that allegedly sank Al Ullman's re-election chances, and nobody in Congress likes to talk about. But the Senate Finance Committee has reported out such a measure (S. 51) to help finance the superfund, by an 18-to-1 vote.

Another measure proposed by Senator William Roth, S. 1102, would levy a "business transfer tax" on a broader value added base with a credit for tax paid against the employer portion of social security taxes. This is receiving a good deal of attention in the Senate Finance Committee right now and will be the subject of another *Federal Tax Policy Memo*.

This memo focuses on S. 51, the "Superfund Excise Tax." Its purpose is to provide the bulk of financing for a greatly expanded superfund to clean up hazardous waste sites. The proposal would levy an 08% tax on manufacturers' sales with credit against tax due at the same rate on direct material costs, utility costs included in cost of goods sold, and costs of manufacturers' equipment. The tax would be imposed on imports and rebated on exports. Depending on the precise treatment of capital equipment, this is conceptually the same base as a tax on manufacturers' value added. Indeed, it was modeled on legislation sponsored by Senators Bentsen and Wallop (S. 957) which openly called for a value added tax. The use of the credit mechanism for narrowing the base to value added instead of the subtraction method or the invoice credit commonly utilized in Western Europe, is intended to save administrative costs—which, however, would still be significant. While the superfund tax would not be collected at the retail or wholesale level, it would be another cost of production which would have to be reflected in final sales to maintain returns to both labor and capital. In other words, the consumer could end up paying for a good part of it anyway.

Another Black Hole?

How S. 51 came about is another chapter in Government's long history of wrestling with "emerging" national problems by starting a relatively small operation that quickly becomes obsolete in relation to the perceived size of the problem. The superfund is not really an entitlement program but its financing process bears a disturbing resemblance to that of medicare and food stamps. Limited financing initially for a small pro-

gram; then suddenly the program is almost open-ended with insistent calls on increased general revenues and or broader taxes.

Basically the 1980 Act (The Comprehensive Environmental Response, Compensation, and Liability Act of 1980 "CERCLA") set up a five-year $1.6 billion program to finance the cleanup of toxic wastes through an excise tax on petroleum and chemical feedstocks and some contribution from general revenues. The legislation expires this month, and it is proposed by everyone including the Administration to expand the superfund considerably because of the high costs of hazardous waste cleanup including, ominously, the high potential costs of damage claims as to natural resources.

Originally it was thought that the parties responsible for hazardous waste sites could be forced to repay the superfund for a large part of cleanup costs. But, aside from direct settlement agreements with EPA outside of the superfund, mostly involving ongoing business concerns, the government has collected virtually nothing to cost recoveries. In many cases, of course, owners of hazardous waste sites have gone bankrupt or cannot be clearly identified with the problem site.

Nobody seems to know what the future costs of full environmental cleanup will run. Estimates go as high as $800 billion involving up to 10,000 sites. This sort of deep-pocket potential financing need should make people very hesitant about new financing structures. Nevertheless, the Administration argues that only a $5.3 billion program over the next five years can be carried out efficiently, in part because of long lead times for planning and remediation operations. The Administration program would be financed mainly by continuing the tax on petroleum and feedstocks and adding a tax on disposal of hazardous wastes.

Those urging a broad-based tax for the superfund claim that there is hazardous waste potential, at least, in all manufacturing operations, and it is unfair to load all of the costs of an expanded program on industry segments. The Administration says it would prefer even general revenue financing to a broad-based tax which could depress business generally. The Senate Finance Committee bought the broad-based tax argument and upped the ante to a $7.5 billion program over five years.

Prospects for adoption of the Finance Committee proposal are quite uncertain. At this writing the House has not acted on it and the press of other legislation might indicate a simple one-year extension of the existing program. But the implications of any new broad-based tax at the Federal level are noteworthy to say the least. The most obvious question is whether or not the rate of tax – below 1% in the current proposal – could be held there in view of the uncertain future costs of cleanup. The record of similar Government initiatives is not encouraging in this respect. And, of course, there are considerations beyond the superfund itself. ***If we go to the trouble of establishing the mechanism for collecting a value added tax on manufactured goods at the Federal level, how easy would it be to extend the base a little, add a percentage point or two to the rate, and finance a little deficit reduction or other worthy cause. No wonder people worry about the black holes in public finance.***

56% of Public Dollars Go for Social Welfare; Would Furnish $2,519 to Each U.S. Resident

Government spent more than half a trillion dollars for social welfare programs in fiscal year 1982 (latest officially reported). This represented 56 percent of all Federal, state, and local expenditures, according to economists at the Tax Foundation.

Social welfare spending in 1982 totaled $592 billion, or $2,519 per capita, according to data recently compiled by the Social Security Administration. It was up 8 percent from the previous fiscal year, and triple what was spent on such programs as recently as 1971. The Federal government accounted for 61.9 percent of the total.

Public social welfare programs, as defined by the Social Security Administration, include social security and public employee retirement, Medicare, Medicaid and cash payments under public assistance, unemployment compensation benefits, health, veterans' services, housing, education, and others.

The largest single social welfare program—Old Age, Survivors, Disability, and Hospital Insurance (OASDHI)—has grown more rapidly than any other social welfare program. Under the OASDHI umbrella, social security taxes finance Federal programs for retirement, disability, and medical care.

Since 1970 OASDHI expenditures have more than quadrupled, amounting to $205 billion in 1982. Spending for this program now claims more than a third of all total social welfare expenditures, Tax Foundation economists say. According to the latest federal budget, OASDHI outlays in fiscal 1985 are estimated at $257 billion, 26 percent higher than in

(Continued on page 4)

"The largest single social welfare program—Old Age, Survivors, Disability, and Hospital Insurance—has grown more rapidly than any other social welfare program."

THE FRONT BURNER

"Baseline Bingo"

Congress voted the first concurrent budget resolution on August 1 and went home. The average taxpaying citizen looking for solace or at least reassurance that something had been done to curtail runaway deficits, looked in vain.

In a rare bipartisan gesture, leadership in both the House and the Senate rejected the budget compromise before the ink was dry. "Like the new Coke, it's just not the real thing," commented Rep. Hank Brown. "It's better than nothing," was the kindest remark Senate Budget Committee Chairman Pete Domenici could manage.

Small wonder. Much of the economic data in the resolution conference report was indecipherable. What could be deciphered was viewed as totally lacking in credibility by politicians and pundits alike.

Take one instance of the hundreds of numbers for which projections were given: the size of the Federal deficit in fiscal 1988. On August 1 the House and Senate resolution predicted a drop to some $231 billion (FY85) to $102.9 billion (FY88). A fortnight later, the Congressional Budget Office (CBO) said the 1988 deficit would be $143 billion. By month's end, the Administration, in its mid-session review of the 1986 budget, foresaw a 1988 deficit "at a current services level" of $295.6 billion. Even in Washington, a spread of $113 billion is a lot of money. Why the discrepancy?

There they go again, juggling economic assumptions and switching baselines.

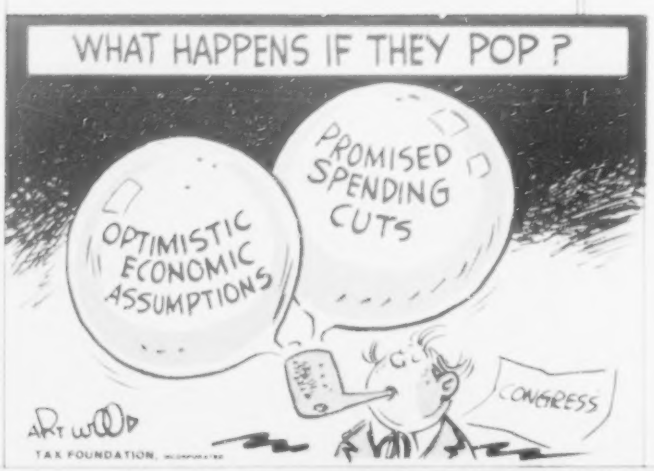
- Congress based the concurrent resolution on Office of Management and Budget (OMB) assumptions published last February.
- CBO used updated economic assumptions.
- The White House ignored Congressional reductions in nondefense spending but did count defense cuts that were reflected in the August 1 concurrent resolution in its projection of the FY88 deficit. In other words, what the Administration is calling "current services" projections were really apples and oranges, economically speaking.

OMB took the Administration's February spending cut proposals for nondefense programs, combined these with Congress's defense reductions, threw in a few revisions of its own earlier economic assumptions, and came up with a budget deficit of $99.8 billion for FY88. This rosy scenario will prevail only if Congress votes the Administration's original spending cuts and if the White House's somewhat optimistic economic assumptions hold true. Two big "ifs."

On the bad news side, using a low growth economic scenario that excludes a recession in 1987, CBO came up with a $372 billion deficit for FY88.

In short, you pays your money and you takes your choice. More accurately, the tax writers and public spenders make their choices and then take our money.

"The tax writers and public spenders make their choices and then take our money."



Social Welfare Expenditures under Public Programs by Source of Funds and Type

Selected Fiscal Years 1960-1982

Item[a]	1960	1970	1980	1982[b]
	Amount (millions)			
Total expenditures	$52,792	$143,836	$492,534	$592,521
Social insurance	19,907	43,691	229,784	288,743
OASDHI	11,642	30,855	142,110	184,568
Public employee retirement	3,278	8,620	34,480	40,091
Unemployment insurance	836	2,825	10,326	23,106
Workmen's compensation	1,998	1,391	12,427	16,911
Public aid	4,391	16,466	41,991	46,746
Public welfare	3,243	11,153	44,888	53,100
Health and medical programs	1,864	4,467	27,667	32,000
Veterans' programs	4,474	9,538	18,402	24,500
Education	17,630	36,646	123,885	153,674
Elementary and secondary	10,220	24,200	67,361	87,417
Higher	4,001	9,465	36,436	49,654
Vocational and adult	406	1,314	4,000	5,000
Housing	183	1,117	3,110	3,114
Other social services	1,253	3,430	7,500	11,500
From federal funds[c]	19,907	57,000	180,000	180,000
Social insurance	11,642	30,855	142,110	184,568
Public aid	1,243	8,000	20,000	30,000
Health and medical programs	1,864	4,467	27,667	32,000
Veterans' programs	4,474	9,538	18,402	24,500
Education	1,253	3,430	7,500	11,500
Housing	183	1,117	3,110	3,114
Other social services	248	593	1,211	1,386
From state and local funds[c]	32,885	86,836	312,534	412,521
Social insurance	8,265	12,836	87,674	104,175
Public aid	3,148	8,466	21,991	16,746
Health and medical programs	0	0	0	0
Education	16,377	33,216	116,385	142,174
Housing	0	0	0	0
Other social services	1,095	2,837	6,289	10,114
	Percentage distribution			
Total social welfare expenditures	100.0	100.0	100.0	100.0
Federal	37.7	39.6	36.6	30.4
State and local	62.3	60.4	63.4	69.6
Public social welfare expenditures as a percent of GNP	10.3	14.1	19.1	20.9

Footnotes:
[a] Includes some expenditures not shown separately.
[b] Preliminary.
[c] Includes expenditures not shown separately.

Source: Social Security Administration, Office of Research and Statistics.

(SOCIAL WELFARE, from page 3)

1982—the latest year covered in the SSA tabulations.)

Traditionally, the largest category of the social welfare program has been public education. It was not until 1976 that education took second place—to OASDHI—among public social welfare programs. At $134 billion in fiscal 1982, education outlays amounted to 23 percent of social welfare spending.

Social welfare spending grew far more rapidly than gross national product between 1950 and 1976. During the latest six years reported, however, GNP and welfare spending increased at the same rate, by 79 percent from 1976 to 1982, in current dollars. Adjusted for inflation, the increase amounted to an average annual rate of 2 percent.

For further details on social welfare spending, see the accompanying table.

(U.S. DEBT, from page 1)

Interest on the debt now amounts to about 38 percent of yearly individual income tax collections. Five years down the road, the Congressional Budget Office (CBO) foresees interest costs of $210 billion by 1990. They will claim more than 40 percent of individual income tax receipts under current law. In fact, these projections are based on somewhat optimistic economic assumptions. They assume that the spending reductions adopted by Congress in its concurrent budget resolution on August 1 will actually come to pass.

Tax Foundation analysts point out that increases in the statutory debt limit are typically larger than the expected deficit in a given year's financial transactions. For fiscal 1986, for example, the Treasury requested a $255 billion increase in the debt ceiling, even though the estimated deficit in fiscal 1986 is $178 billion. This is so because the debt ceiling also allows for increases in debt sold to trust funds whose surpluses must (by law) be invested in public debt securities. The interest received on these government accounts serves to reduce the gross costs of interest on the Federal debt to the net interest figure reported in the budget.

The table on page 1 provides additional details.

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TAX·FEATURES

Gramm-Rudman-Hollings Measure Leaves Major Questions Unanswered

New Watchdog Committee Bolsters TF Oversight Of Federal Budget Action

The Tax Foundation has established a Shadow Committee on the Federal Budget to scrutinize official budget and fiscal reports of the Federal government and provide reliable information on them in clear and concise English. The Washington-based tax watchdog organization has assembled a team of experts to conduct this ongoing audit of the Federal budget and its economic implications. The group is patterned on the Shadow Open Market Committee, the existing private sector effort to assess the Federal Reserve's conduct of monetary policy.

Objective Scrutiny Needed

Budget and fiscal policy reports from any Administration and any Congress are by their very nature political documents. The Administration has a built-in bias to understate the budget dilemma, and Congress has a similar bias driving it to attack the Administration's budget and press for changes.

The Congressional Budget Office was set up in 1974 as a check on any Administration's budget claims. While CBO has done some good work, it also has added more confusion to the budget process. The result is widespread uncertainty over such seemingly simple matters as the proper "baseline" (starting point) for measuring proposed changes in spending and Federal revenues. Budget cuts claimed on paper fail to materialize as baselines are juggled at the whim of the estimators on Capitol Hill and in the White House.

In setting up the Shadow Committee, Tax Foundation's Trustees sought to ensure that an independent agency could exist that might work to keep the baselines and estimates honest and accurate.

This is particularly important now because of the Gramm-Rudman-Hollings budget initiative which calls for 10 percent across-the-board spending cuts whenever deficit reduction targets for the next five years are not met. This will intensify the need for such a private-sector effort to sort out what is—and what isn't—real deficit reduction.

Plain English Needed

Another major aspect of the current budget debate is

(Continued on page 4)

"A bad idea whose time has come."

The above words of one of its principal sponsors, Senator Warren Rudman (R-NH), may be the most apt description of the Gramm-Rudman-Hollings (GRH) balanced budget initiative. What started out as one of our perennial after-the-fact protests about the size of the national debt is now the law of the land, mandating a staged reduction in the Federal budget deficit to zero by 1991. Despite widespread dissatisfaction with the measure, it was approved by comfortable margins in both the House and Senate. Many Congressmen held their noses while voting for it but approved it nevertheless to show the state of frustration and desperation over our budget/debt situation. The Administration had reservations about the impact of GRH, too, particularly on defense spending. But the President committed early to the concept and went along with changes insisted on by the House.

The table below shows the budget deficit-reduction targets by fiscal year.

Like past legislative efforts to pose a balanced budget, GRH prescribes no way to get there in terms of substantive changes in specific expenditure programs. It does not even mention the possibility of tax action except for an oblique reference to the corporate minimum tax. It does carve out and safeguard certain

(Continued on page 2)

THIS ISSUE:

PAGE 1:
Gramm-Rudman Shadow Committee

PAGE 3:
Public Service Award

Front Burner: Budget Oversight

PAGE 4:
Conference Summary

INSERT:
House Tax Bill

Federal Deficit Projections Under Current Policy and Gramm-Rudman-Hollings

Fiscal Years 1986-1991
($bils)

	1986	1987	1988	1989	1990	1991
(A) Current Services Budget as of August 30, 1985	242.6	253.1	255.9	243.8	237.9	
(B) Mid-Session Review of Fiscal '86 Budget	177.8	139.3	99.8	53.6	17.7	
(C) "Realistic" Current Policy Budget, January 1, 1986 (average of A + B)	210	196	178	149	128	100
(D) G-R-H Deficit Targets	172	144	108	72	36	0
(E) Potential Mandated Budget Cuts[1]	12[2]	52	70	77	92	100

[1]For fiscal 1987-1990, the deficit targets must be missed by more than $10 billion for sequestration to be ordered.
[2]Limited by formula to $11.7 billion in fiscal 1986 only.
Sources: Office of Management and Budget, Tax Foundation computations.

(GRAMM-RUDMAN, from page 1)

expenditures—interest on the national debt, social security and most other entitlement programs—from automatic cutbacks. As these constitute a significant portion of the overall budget, GRH has been called another empty gesture on budget control.

But unlike the Byrd amendment of 1978 and other past efforts at budget balance, GRH does provide for a mandatory "sequestration" procedure, whereby if deficit targets are not being met by the prescribed time in the budget cycle, automatic percentage reduction to achieve that target is ordered with a 50-50 split of the overall reduction between defense and non-defense areas of the budget subject to the sequestration order. This is the general rule with some special rules applying to fiscal 1986, cost-of-living adjustments on Federal pensions, health programs, unemployment compensation, student loans and some other areas. Also, the whole process could be short-circuited by recession or forecast of recession.

The sequestration procedure is the "club" which GRH sponsors believe will force the Administration and Congress to get serious on budget control. The optimists claim that the existence of the "club" should be enough to ensure deficit target compliance ahead of the mandatory cutback procedure and that the actual sequestration order won't be necessary.

"One major certainty about GRH. It will change radically the way budget decisions are made."

Pessimists point to the failure of existing budget legislation and timetables even to agree on what the budget dimensions should be, let alone prevent a spiraling deficit. They claim that GRH will overlay budget policy with a thicket of new procedures that result more in lengthy new disputes rather than effective enforcement. Besides, it may be declared unconstitutional by giving too much power to the Executive Branch or to the General Accounting Office (GAO).

Legitimate major concerns about GRH relate both to the objective and procedures. First, of course, there is the sheer *potential* magnitude of the task as outlined in the table. Potential is emphasized, but it's so difficult to tell where we are even starting from in terms of baseline budget deficits. The current service budget of last August—which assumes no policy changes at all—is probably too pessimistic for the future. The mid-year session review of OMB, also as of August 1985, is too optimistic because it assumes full implementation of budget cuts under the First Concurrent Resolution for fiscal 1986 in the defense area and much deeper cuts in the non-defense area which Congress is resisting. Also, the cost of the current farm bill and farm credit bailout are not reflected. As of yearend 1985, the most realistic budget deficit projection would approximate an average of the two.

Much, of course, depends on the growth of the economy itself. If it slows significantly but does not go into a recognized recession, the mandated budget cuts could be far, far larger than portrayed in the table. And in any event, the job will be complicated further by putting so much of the budget entitlement programs off limits to sequestration. Approximately $428 billion or 44 percent of the fiscal '86 budget request would be off limits entirely and more, particularly in the health area, would be subject to only small cuts. This means that when the real crunch comes for fiscal 1987, Congress and the President could be seeking to cut (or raise new taxes) equivalent to at least $50 billion, or about 10 percent of the pertinent base. In an economy with some inflation this poses a formidable but by no means impossible task.

One major certainty about GRH. It will change radically the way budget decisions are made—in the bunching of mandatory time-dated actions, the forcing of critical forecasts of inherently murky numbers, and the perhaps casual disregard of the impact on the economy of major budget shifts. And that will make the task of those trying to track the course of budget policy much tougher. The need for private sector watch-dogging of the figures will be even greater.

Tax Foundation Working Paper of December 20, 1985, gives more complete analysis of Gramm-Rudman-Hollings. See below for details on ordering this and other Tax Foundation Working Papers.

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FEDERAL TAX POLICY MEMO

Editor: Edward A. Sprague, Vice President–Tax and Economic Affairs

JANUARY 1986

The House Tax Bill

What can be said about the 1,363-page House version of tax reform in one tenth of one percent of the space? For one thing, they did have the decency to take "simplification" out of the title. This was an oft-stated objective of the popular flat tax and other proposals of recent times and found prominent mention in the Treasury Report of November 1984, "Tax Reform for Fairness, Simplicity and Economic Growth."

Simplicity has not vanished entirely in the House bill. Many individuals would find it easier to compute their tax liability, particularly if they are among the estimated six and a half-million low-income filers to be dropped from rolls entirely or among the additional millions who would be encouraged to switch from itemizing deductions to the standard deduction. But for those who would have to compute the new alternative minimum tax and for virtually all businesses—large or small, economic beneficiary or loser from tax change—tax matters would be more complicated and careful tax planning even more important. The potential transition problems alone are staggering, especially in areas such as capital recovery with the abandonment of the Accelerated Cost Recovery System (ACRS) and the investment credit and the institution of a new depreciation system with minor indexing attached.

Some more complexity was inevitable as the purer ideas of tax reformers were ground through the legislative mill. Some of it also reflected the particular way this piece of legislation was handled—the leisurely pace of post-Treasury Report massaging by the Administration and the extensive trading of interests within the Ways and Means Committee.

The dimmer the prospects for simplification, the less interest the general public seemed to take in tax reform. By summer 1985, public sentiment had identified tax reform as just another Washington dance, and the President was having great difficulty in generating support for the program. In the end, the House bill was adopted mainly because of the commitment of the House leadership and an extraordinary effort by the President to rescue the measure from ambush by House Republicans.

Aside from lost simplification and last-minute political histrionics, there is a degree of continuity in the major themes of tax reform as set out in the Treasury Report of 1984 and as evolved in the House bill. These are:

(I.) Rate reduction and strengthening of tax-free allowances.

(II.) Limited base broadering in the individual sector.

(III.) Shift of tax burdens to the business sector.

(IV.) Overall revenue neutrality, at least for the next five years.

Another major theme was added to the process later on: the alternative minimum tax.

A few comments on how these played out:

(I.) Rate Reduction and Allowance Increases

The individual tax rate formula of Treasury I—15-25-35 percent—gathered moral authority of its own over the past year. Even with the additional 38 percent top rate, the House bill came closer to it than many thought possible, particularly after retaining full deduction for state/local taxes. The slightly asymmetrical 15-25-35-38 individual rate schedule proposed in the House measure must stand as a singular accomplishment whatever the eventual fate of reform.

To be sure, there is less incentive value in the way the Ways and Means Committee constructed its rates. Marginal rates after the first 15 percent cut in at *significantly lower levels of income* than under the Administration program. For joint returns, for example, the House marginal rate is 25 percent over $22,500, 35 percent over $43,000, and 38 percent over $100,000. This compares with the Administration's 25 percent over $29,000 and 35 percent over $70,000. As a result, married taxpayers currently with $43,000-$49,000 in taxable income actually would face a two point increase in their marginal rate, from 33 percent to 35 percent, even though their overall effective rate of tax might fall. Approximately 9 percent of all joint returns would be affected by this notch, which would also be a problem for single and head-of-household returns as well. These lower thresholds of tax were deemed necessary because of more limited base broadening and the more decided tilt to the lower income groups under the House measure.

The importance of a potential twelve point or greater reduction in the top marginal rate should not be overlooked. This could have a significant impact on work and savings incentives—more so perhaps than the twenty point reduction from 70 percent to 50 percent in 1981. The latter's impact was obscured by the previous dual treatment of income—earned income taxed at a maximum of 50 percent and so-called "unearned" or investment income at 70 percent. A maximum rate of tax in the 35 to 38 percent range could prove effective in diminishing interest in uneconomic tax shelter investments—more effective in this respect probably than the complicated minimum tax proposal in the House bill. Until rates are reduced sufficiently so that the combination of Federal and state marginal rates are well below 50 percent, we will not get a true test of the "market" approach to encouraging productive investment as opposed to tax-motivated shelter investments.

One important drawback to encouraging investment overall, however, is the House bill's increase in the effective capital gains rate to a maximum of 22 percent, compared to 20 percent currently, and the retention of long-term capital gains as a preference income item subject to a stiffer alternative minimum tax. Higher capital gains taxes without any indexing of

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basis would run counter to the thrust of marginal rate cuts on ordinary income.

As for allowances, Treasury I got the ball rolling on a large increase in the personal exemption and some increase in the standard deduction (or zero bracket amount). The House went along with this thrust but raised the standard deduction more (to $4,800 for joint return in 1987) and limited the proposed $2,000 personal exemption to non-itemizers. Those itemizing deductions, in effect, would have their personal exemption set at $1,500, although inflation indexing would raise the levels for both itemizers and non-itemizers in the future.

This split personal exemption saves some revenue while allowing more relief to flow to the lowest income groups, who, more typically, are non-itemizers. In conjunction with light treatment of most fringe benefits, the overall result of the House measure, not surprisingly, would be to rearrange the benefit of tax reduction down the income scale. This is shown in the table below comparing the distribution of tax change by income group for the Administration's program of May 1985 and under the House bill.

Percentage Change in Income Tax Liability By Income Class (1987 Level)

Income Class ($000)	Administration Program	House Bill
Less than 10	-35.5	-76.0
10 - 15	-22.8	-23.4
15 - 20	-13.5	
20 - 30	- 8.7	- 9.9
30 - 40	- 6.6	- 9.0
40 - 50		- 8.7
50 - 75	- 4.2	- 7.4
75 -100		- 5.7
100-200	- 4.1	- 7.3
200 and above	-10.7	- 5.9
TOTAL	- 7.0	- 9.0

Sources: "The President's Tax Proposals for Fairness, Simplicity and Economic Growth," May 1985 and Ways and Means Committee Report on H.R. 3838, December 7, 1985.

The House bill clearly is more generous to the lowest income groups, slightly more generous to middle-income groups, and "takes away" some benefit from the over $200,000 group relative to the Administration program, mainly as a result of the proposed alternative minimum tax and slight increase in the maximum capital gains tax. The House bill's overall reduction for individuals is also marginally greater than under the Administration program.

With the shuffling of rates and allowances, the House bill still would not produce any dramatic shift in relative tax burdens. The overall structure would remain "progressive," in some respects, even a little more progressive. The average tax rate of those in the below $10,000 income class would be cut very sharply, but in dollar terms they don't pay very much anyway under present law.

One of the least controversial thrusts of current tax reform has been to cut low-income taxpayers off the rolls. The Administration program emphasized this objective, and the House bill certainly obliged with higher tax-free allowances and an increased earned-income credit. Approximately six and a half million returns, or about 6 percent of the individual return base, would be dropped out of taxpaying status by the measure.

Average Income Tax Liability and Tax Rate, Present Law and Committee Bill, by Income Class, 1987

Income Class ($000)	Tax Liability		Average Tax Rate	
	Present Law	Committee Bill	Present Law	Committee Bill
0 - 10	$ 68	$ 16	1.4	0.3
10 - 20	886	678	5.8	4.4
20 - 30	2,168	1,954	8.3	7.5
30 - 40	3,346	3,045	9.3	8.5
40 - 50	5,100	4,658	11.0	10.1
50 - 75	8,166	7,563	13.2	12.2
75 - 100	14,223	13,407	16.0	15.1
100 - 200	28,245	26,196	19.8	18.4
Over 200	136,714	128,711	23.5	22.1
All	$ 3,210	$ 2,919	11.3	10.5

Source: Ways and Means Committee Report on H.R. 3838, December 7, 1985.

A consensus assumption is that nobody below the poverty level should be subject to Federal income tax, and it is hard to argue with that sentiment. In the House bill, however, the tax threshold for joint and head-of-household returns is well above the estimated poverty level—up to 57 percent higher if the earned-income credit is included. The poverty level itself, of course, is an arbitrary statistic, not reflecting in-kind welfare benefits or actual living conditions.

An older school of thought held that all citizens with income should pay at least something toward support of the Federal government through its principal revenue source to give them some stake in how public expenditures were made. This has been swept under the rug in the rush to embrace a populist reform plan.

II. Base Broadening

Expansion of the individual income tax base by cutting out or reducing special exclusions, deductions, and credits has been the tax reformers' dream for decades. But the nirvana of true neutrality continues to elude us. Base broadening is very limited in the House bill.

The original Treasury I program opted to retain some popular deductions—mortgage interest in particular—and this raised pressure on both the Administration and Congress to keep more. The big issue, of course, was state/local taxes. It was said that the Ways and Means Committee kept the state/local deduction to gain votes for the overall reform package. But the Administration never really made a good case for eliminating the deduction in the first place. Its argument that high-tax states were being subsidized at the expense of low-tax states through the Federal deduction was not convincing when individual taxpayers had relatively little choice in the matter.

Most of the attempts to tax fringe benefits also went down to defeat. Administration flip-flops on which way to tax employer-provided medical insurance premiums set up that proposal for a knockout by labor interests. Taxation of group life insurance premiums (under $50,000 in coverage) was also dropped. The House did, however, extend tax to all unemployment benefits and made some very significant changes in retirement income provisions, mostly to increase the tax bite. (The latter area is treated by a special Tax Foundation working

paper, "Tax Treatment of Retirement Savings—Success Under Attack.") The only other significant additions to the regular individual tax base in dollar terms were eliminations of the two-earner deduction and income averaging.

Overall, by five years out in fiscal 1990 (when most all provisions would be fully phased in), the House measure would pick up a "reported" $38 billion in additional revenue through changes in special exclusions, deductions, and credits (not including the proposed $500 floor on itemized deductions which is considered less of a tax break for itemizers than a base broadening). This $38 billion would amount to about 7 percent of estimated total individual income tax receipts in fiscal 1990 assuming the rate reductions were in place, too. This is about 38 percent of the amount of similar base broadening under the Administration program for the same year. If the state/local tax deduction is not reflected in this comparison, the House base broadening would amount to 63 percent of the Administration program.

III. Business Provisions

For the business community the good news list about the House bill is pretty short. It's the corporate rate reduction from a top rate of 46 percent to 36 percent on income above $75,000—still three points higher than the Administration proposal—and similar cuts for small corporations with income below $75,000. The bad news goes on quite a bit longer and culminates in $139 billion in net additional corporate income taxes over the 1986-1990 period. This is about $20 billion more than reported for the Administration's May 1985 program. According to the Joint Committee on Taxation, the House measure would raise the share of corporate income tax receipts from 16 percent of total income tax receipts, currently, to 23 percent in fiscal 1988 and 1989, settling back a bit afterward.

How we got to such a sizeable proposed increase in business taxes only four years after the big cuts under the Economic Recovery Tax Act of 1981 (ERTA) makes an interesting story, which we don't have space to detail here. But the key developments were:

(1) The Treasury I report broke the mold of the leading congressional tax reform proposals—Bradley-Gephardt and Kemp-Kasten—both of which aimed at revenue neutrality *within* the individual sector and *within* the corporate sector. Treasury I framers claimed that its higher tax burden on business was not deliberate in itself, but was the result of a rigorous application of tax "neutrality" among industries, better measurement of income, and keeping the top corporate and individual rates close together. Maybe so, but the increase in business taxes did happen to facilitate a net reduction in individual taxes, especially the generous $2,000 personal exemption, while keeping the overall package revenue neutral on paper. The cat was out of the bag.

(2) The long-term shrinkage in the corporate income tax as a share of total Federal revenues or income tax revenues was accelerated by ERTA in fiscal 1982-1984. Also a spate of "studies" were calling attention to the alleged low or negative effective rates of tax of some major corporations and business sectors. Much of the material in these studies was not relevant for public policy purposes, but they attached an undeniable stigma to the whole corporate sector in terms of perceived fairness of the system. The Ways and Means Committee report on H.R. 3838 stresses the need "to restore the traditional balance of the income tax between individuals and corporations" as a justification for net tax increases on business and to restrict "the ability of corporations to eliminate their tax liability," a rationale for the tougher corporate minimum tax. Interestingly, a good part of the decline in the corporate tax share attributed to the ERTA capital recovery liberalization would have reversed itself naturally in future years as the benefit of accelerated depreciation was used up. Congress, however, was not willing to wait.

(3) The real split in the business community obviously helped facilitate some business-bashing in the bill. Those favoring lower corporate rates as a top priority generally supported the measure. The opposition, particularly among the capital-intensive industries, was louder but not effective in trying to turn the central thrust of reform away from business tax hikes. Small business interests, which generally are well represented on the Hill, were also split. But as the Ways and Means Committee markup went on, small business opposition was neutralized by a series of concessions exempting small business from much of the base-broadening tax increases—and complicating tax planning in the process, of course.

As for the economic results, should the thrust of H.R. 3838 be enacted into law, we would be taking a bit of a gamble. We would be betting that the lower tax rates in both individual and business tax sectors, combined with some evening of tax burdens among economic sectors, would encourage economic efficiency and growth, despite the increased cost of capital in the industrial sector.

On the plus side, the corporate rate reduction is important, to be sure. Even if it doesn't reach the full thirteen point drop proposed by the Administration, a top rate of no more than 36 percent would help stimulate market investment, whether labor or capital intensive, as after-tax returns are increased. The incentive effect on investment would be enhanced by the tandem reduction in both the individual and corporate rates, which we have not had on the same order of magnitude in any of the previous post-World War II tax reduction measures. When the prospective contribution of individual investors is considered, a net tax increase on the corporate sector might be viewed as somewhat less threatening for overall capital formation and growth.

But threatening it still is, particularly in the capital recovery area. The stretchout of depreciation under the House bill is very significant for long-lived assets. With a four percent inflation rate, the present value of depreciation allowances for industrial machinery is 21 percent less than under ACRS and for commercial real estate, 40 percent less. This, in combination with the loss of the investment credit, certainly presents a sea change in capital recovery policy compared to the prior trend. Even a low rate of tax can have adverse impact on plant and equipment investment without an effective capital recovery system. And this point is sure to be raised in the Senate consideration particularly as it relates to international competition.

One provision the House did not adopt was the depreciation recapture scheme proposed by the Administration in its May 1985 program. This was very unpopular, not only among

those who would be directly affected but also as a precedent for other types of investment that might be hit with retroactive tax hikes.

The House bill did pick up many of the other tax increases in the Administration program affecting a wide range of domestic and foreign business enterprise. It modified some, offered small business exemptions to some, and added a few of its own. The stated objective was to reduce tax "subsidies" to particular industries or through particular accounting methods.

At this point, there is no way to assess with any accuracy the overall impact of so many changes in tax treatment—except that they would increase costs of doing business in many respects and would condition both market behavior and the revenue estimates attached to tax reform.

IV. Revenue Neutrality and the Alternative Minimum Tax

In the major 1969 and 1976 tax bills, measures of reform were eased through with a dose of tax relief mostly for low- and middle-income individuals. In the context of our multi-billion budget deficits today, a major tax reform bill probably cannot be written without a firm commitment to no net loss in revenue. This target did serve as a form of glue keeping the process from disintegrating. While some business representatives argued that economic growth from rate reduction should be reflected more in the revenue estimates to lessen the need for tax increases elsewhere, there is not yet agreement on how to measure that growth for purposes of legislative policy decisions. The Ways and Means Committee fell back on the Joint Committee on Taxation's traditional method of revenue estimating and achieved a paper balance, at least over the five-year forecasting period.

All sorts of things could, and, in fact, are very likely to, go wrong with such projections as the economy adapts to extensive tax change. By tightening depreciation treatment drastically now, either the House bill or the Administration program would become decidedly unbalanced in the future beyond fiscal 1990 as short-term revenue gains peter'out. With its indexing proposals, mostly ignored by the House, the Administration program could result in even larger future revenue drains depending on the future course of inflation.

In any event, in the House bill, the constraint of revenue neutrality, in conjunction with other political objectives, was to seal a large business tax increase and encourage the adoption of a stiffer alternative minimum tax on both individuals and the corporate sector. By adding more preference items to the base and by greatly diminishing the differential between the regular tax rate and the alternative minimum tax rate, the House, in effect, would create a dual income tax structure—one that millions of taxpayers would have to contend with whether or not they would end up with minimum tax liability.

Outlook

One known result of the House bill is the confusion it is causing already for a lot of taxpayers. Many of the effective dates of base-broadening provisions were set for January 1, 1986, or even earlier. While most assume the House and Senate will agree to move effective dates forward, there's no guarantee of that, particularly with regard to incentive type provisions such as the investment credit. Meanwhile, in the press of haggling over the tax bill and the budget reconciliation measure, a number of tax credit provisions, affecting numerous activities, from research and development to solar energy, were allowed to expire on December 31st. Some of these would be continued under the House bill and some wouldn't. But, as of this writing, the House and Senate have not agreed on how to extend them even temporarily.

There is some indication that uncertainties about the fate and timing of capital recovery provisions are having a negative effect on business capital spending plans for 1986. If so, this will tend to reinforce the President's call to retain "basic tax incentives for American industry" in the Senate consideration. What that would mean specifically in terms of changes in the capital recovery provisions from H.R. 3838 isn't known.

The President also has stated that he would veto any reform bill that did not include a full $2,000 personal exemption, at least for those in low- and middle-income brackets, and maximum rates no higher than in his proposal. It's not clear whether he was referring to both the corporate and individual rates or just an individual top rate of 35 percent. The latter, it would seem, is the bottom line requirement for Administration approval of a reform measure.

These stated Presidential requirements don't appear to give the Senate much wiggle room and still allow them to come up with a revenue neutral package. However, it could be done by exchanging even lower tax thresholds for the 35 percent top rate and by a restrictive interpretation of which middle-income brackets are eligible for the full $2,000 personal exemption. Another way, of course, to meet the President's requirements would be to repeal some of the state/local tax deduction. But the Senate does not seem likely to bite that bullet after the House took the state/local tax deduction off the table.

A more critical threat to the tax reform effort in the Senate is a collision with Gramm-Rudman-Hollings mandated budget deficit reductions. If these turn into tax increase proposals, as many assume they will, a revenue-neutral tax reform bill could become irrelevant and unravel. It should escape nobody's attention, of course, that in H.R. 3838 we have legislative language for literally hundreds of tax increases that could be lifted directly from a reform package and be put in a deficit reduction package without the rate reductions. (Query: how many of these could be considered "revenue enhancers"?) The Gramm-Rudman-Hollings legislation itself does direct Congress to come up with a corporate alternative minimum tax to help reduce the deficit, and that's front and center in H.R. 3838.

Alternatively, Congress could turn to a new source of revenue, such as an oil import fee—once again being talked about—or even a business transfer tax. In the meantime, the Senate Finance Committee will plod on with new hearings and a markup aimed at revenue-neutral tax reform, probably along the lines of the House bill. Even without public clamor for it, tax reform does have a momentum of its own. By mid-Spring, probably by April 15 tax day, we should know if that momentum is strong enough to carry it through the Congress.

Treasury's James Baker, III Cited for Public Service

Significant tax reform *can* happen," Secretary of the Treasury James A. Baker, III, told Tax Foundation's Annual Dinner December 4th. Secretary Baker addressed Tax Foundation Trustees and other leading corporate executives and media representatives who had gathered at the Waldorf-Astoria Hotel in New York for the Foundation's 48th Annual Dinner. The Treasury Secretary also received the Foundation's Distinguished Public Service Award for 1985 from Hans W. Wanders, President of the Wachovia Corporation and newly elected Chairman of the Foundation's Board. Secretary Baker outlined the Administration's tax reform goals, which he summed up as "fairness, simplicity, and economic growth."

Describing the fundamentals behind the proposals as "market-oriented populism," Secretary Baker listed six key elements of the President's plan:

- "First, we must lower personal rates."
- "Second, we must broaden the tax base through the reduction of preferences and shelters."
- "Third, we must not place the tax burden on low-income people."
- "Fourth, we seek equitable treatment of different businesses."
- "Fifth, we want to achieve lower corporate rates in a manner consistent with an overall interest in capital formation and growth."
- "Sixth, the reform must be revenue neutral."

Calling both the Democratic tax bill, which passed the House December 3, and the Republican substitute, which was voted down, "flawed in several respects," the Secretary noted "they represent an important start toward meaningful tax reform."

THE FRONT BURNER

By Robert C. Brown
President
Tax Foundation, Incorporated

"Shadow Budget Committee"

This year sees the birth of a new entity at the Tax Foundation—the Shadow Committee on the Federal Budget. Designed to keep an eye on the conduct of the Federal budget debate, the Shadow Committee has only one public—the American taxpayer.

Any budget—every budget—is a political document. The White House designs the budget to make the incumbent President look good, and look even better, as they say, "in the out years." The Congressional Budget Committees respond but keep in mind the interests of incumbent Representatives and Senators. Most often, those interests are all too short term—re-election the next time out. The Congressional Budget Office has struggled heroically, first under Alice Rivlin and now under Rudy Penner, to remain nonpartisan. To its credit, CBO has largely succeeded here. With 535 elected Members of Congress as its boss, the CBO has been less successful in its pursuit of accurate statements of the budget condition.

Where this leaves the general public is asking the perennial question: "Who will guard the guards?" When public officials prove incapable of putting the public interest before their own political objectives, who will point this out?

In the area of national budget policy, the Tax Foundation's Trustees have come up with an answer: The Shadow Committee on the Federal Budget. Perhaps without fully realizing it, the Foundation has been evolving toward such a vehicle for a number of years. As spending outpaced taxation as a headline grabber, our analysts found themselves confronting budget issues with increased frequency. Given the available staff and resources, something had to be done if the Foundation's traditional excellence in objective analysis and reporting was to be sustained. The answer, again, was the Shadow Committee.

The Trustees were fortunate, indeed, in finding public citizens of the character and expertise of those who have agreed to serve as charter committee members. Leif H. Olsen has repeatedly shown his ability to track and interpret public economic issues as Chairman of Citibank's Economic Policy Committee. Harry F. Byrd, Jr., former Senator from Virginia and longtime Trustee of the Tax Foundation, has a vast store of wisdom garnered over 17 years in the United States Senate, including lengthy service on the Senate Finance Committee. W. Bowman Cutter brings extensive experience in the Office of Management and Budget and now in the private sector with a major CPA firm in Washington. Al Ullman, with nearly a quarter of a century in the Congress, including many years as member and later chairman of the Ways and Means and Budget Committees during a number of crucial debates, is a vital contributor to the team. Finally, Allen Schick, professor in the School of Public Affairs at the University of Maryland, and formerly a budget analyst with the Congressional Research Service, probably has as comprehensive a grasp of the Federal budget process as anyone working in this complex and sophisticated field.

The Committee now exists. Its operation has begun. Washington will dictate the agenda. Evolving circumstances will ultimately shape the Committee's understanding of itself and of the statements and reports it issues. As the distinguished members launch their effort, we wish them a successful voyage over the rough water of the budget debate.

"When public officials prove incapable of putting the public interest before their own political objectives, who will point this out?"

"Another major aspect of the current budget debate is that budgetary documents are written in complex bureaucratese and provide little or no understandable guidance for the American public."

TF's 37th Conference Probes U.S. Tax and Deficit Issues

"The Tax Agenda—Level Field or Minefield?" served as the theme of Tax Foundation's 37th National Conference in New York December 4th. Speakers probed a wide range of issues dealing with the economy, tax policy, and the impact of trade and budget deficits on tax reform.

Norman Robertson, Senior Vice President and Chief Economist of Mellon Bank, keynoted the meeting with an overview of the economy for 1986. He predicted that the economy would continue to expand in 1986, but at a slower rate—"2-2½ percent or less by the second half of 1986," he said.

Don Fullerton, Deputy Assistant Secretary for Tax Analysis of the Treasury Department, and John S. Nolan of Miller and Chevalier, a Washington law firm, discussed "Business Tax Policy—Forging a New Consensus?" The Business Transfer Tax was evaluated by Ernest S. Christian, Jr., a partner in the Washington law firm of Patton, Boggs & Blow, and James P. Bryant, Vice President and Director of Corporate Taxes for J.C. Penney Company, Inc.

W. Michael Blumenthal, Chairman of the Board and Chief Executive Officer of Burroughs Corporation and former Secretary of the Treasury, was the featured speaker at the conference luncheon.

The former Treasury Secretary expressed five reservations about the current tax proposals:

- The tax debate diverts national attention from the budget deficit.
- The tax bills worsen both the undervaluation of the dollar and the lack of competitiveness of U.S. industry.
- They are pro-consumption and anti-savings and investment.
- They are anti-investment in research and development.
- They may be revenue neutral, but even so, "we need more revenue."

"There simply is no credible solution to the budget problem without new taxes," Blumenthal charged. "And the tax bills evade this issue altogether."

He called for "new taxes—new sources of revenue. That is the issue which we must face."

[The full text of Blumenthal's speech appears in the fall issue of Tax Foundation's *Fiscal Policy Forum*. Copies of this issue are available from the Foundation's Office of Public Information.]

The afternoon session of the conference looked at the "Two Deficits"—budget and trade—and whether these would overshadow tax reform. Rudolph G. Penner, Director of the Congressional Budget Office, discussed the budget deficit; and Clarence J. Brown, Deputy Secretary, U.S. Department of Commerce, discussed the trade deficit.

More than 350 business executives, media representatives, government officials, professors and students of economics and political science attended the day-long conference at the Waldorf-Astoria Hotel. The sessions were followed by the Tax Foundation's 48th Annual Dinner at which Secretary of the Treasury James A. Baker, III, received the Foundation's Distinguished Public Service Award for 1985. (See accompanying article, this issue.)

(SHADOW COMMITTEE, from page 1)

that budgetary documents are written in complex bureaucratese and provide little or no understandable guidance for the American public. The reports, because they are virtually unintelligible to the general tax-paying citizen, carry less and less credibility and command less and less attention—inside or outside of Washington.

Tax Foundation's Role

Since the days of the New Deal, the Tax Foundation has earned a reputation for the accuracy and credibility of its ongoing program of research and public education on the tax and fiscal activities of all levels of government. The Trustees felt it was the logical organization to assemble a team of experts, to raise from nongovernmental sources the funds needed to carry on the project, and to sponsor a continuing audit of the Federal budget and its economic implications.

Continuous Oversight

As a continuing private-sector effort to track and analyze the development of the Federal budget for each fiscal year, the Committee will focus on:

1) The reasonableness and internal consistency of underlying economic assumptions.

2) The believability and achievability of proposed budget changes in terms of authorizations, expenditures, receipts and changes in government credit programs, whether on- or off-budget.

3) Analysis of the same points under (2) above for the Administration's initial budget presentation, any substantial revisions including midyear review, the Congressional Budget Office response to the Administration budget, the House-Senate Concurrent Resolution on the budget, and other reports as necessary.

4) The implications of alternative budget approaches, actions and inaction.

5) Publication of the results of such analyses in a manner designed to ensure widespread distribution and attention, including press conferences to which Washington-based national media would be invited.

The Committee

Leif H. Olsen, Chairman, Economic Policy Committee of Citibank, N.A. (1977-1985), will chair the Shadow Committee on the Federal Budget. Serving with him will be:

- The Honorable Harry F. Byrd, Jr., United States Senator from Virginia (1965-1982); member, Committee on Finance (1969-1982).
- W. Bowman Cutter, Partner, Coopers & Lybrand; Executive Associate Director for Budget, Office of Management and Budget (1977-1981).
- Allen Schick, Professor, School of Public Affairs, The University of Maryland; former Senior Specialist, Congressional Research Service.
- The Honorable Al Ullman, United States Representative from Oregon (1957-1981); chairman, House Budget Committee (1974); chairman, Committee on Ways and Means (1975-1981).

The Shadow Committee on the Federal Budget will hold its first session February 5 in Washington, at which time it will examine and respond to the President's Budget Message.

Further details are available from Tax Foundation.

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TAX FOUNDATION'S VOL. 30, NO. 2 FEBRUARY 1986

TAX·FEATURES

State-Local Property Taxes Up 8%; Wyoming and Alaska Lead the Pack

State and local property tax revenues rose 8.3 percent in fiscal year 1984, to $96.5 billion. This $7.3 billion increase, while slightly smaller in percentage terms, is of similar magnitude to the revenue gains amassed in the previous three years.

In contrast, the 1977-1980 figures showed an average yearly expansion of only 3.1 percent. This was largely attributable to the effects of California's Proposition 13 on overall totals, according to Tax Foundation economists. (In 1979, the first full year in which the limitation was in effect, it slashed California's property taxes by 45 percent, triggering a 2 percent decline in the national totals.) Since 1980 property taxes nationwide have grown by over 40 percent, an average rate of 8.9 percent a year.

Over the past ten years, property taxes more than doubled, rising by 102 percent from the $47.7 billion collected in 1974—an average annual rate of 7.3 per-

(Continued on page 4)

13¢ of Every Tax $1 Slated For Huge U.S. Health Bill

National health expenditures hit $355 billion in 1983. This was more than eight times what they were in 1965, according to Tax Foundation researchers.

Federal, state and local governments picked up $149 billion of the health-care tab, with 70 percent ($103 billion) of the total coming from Uncle Sam. State and local funds anted up the remaining $46 billion.

National health spending includes such items as patient care, medical research, and construction of medical facilities.

Since 1975, tax funds have provided about 42 cents of every dollar spent on the nation's sharply rising health bills. In 1965, taxes furnished only 26 cents. National health spending from all sources amounted to $1,459 per capita in 1983, compared to $211 in 1965. Health outlays claimed 10 8 percent of gross national product (GNP) in 1983 compared to 6 percent in 1965.

The Health Care Financing Administration (HCFA) estimates that national health spending hit $420 billion in calendar year 1985, of which government's share was $180 billion—$128 billion for the Federal government and $52 billion for states and localities.

The numbers tell the story of how steadily Uncle Sam's involvement in health care has grown over the years. In 1983 private health care spending was about 7 times its 1965 level and state-local health spending was scarcely more than twice its previous size, but Federal spending was 19 times as large as it was in 1965. Health care costs today claim 13 cents of every government budget dollar, in contrast to 6 cents in 1965.

Medicare and Medicaid are the engines driving the sharp growth of government health costs. These two largest government health programs, enacted by Congress in 1965, now account for nearly two-thirds of all health-related government spending and for over one-quarter of the total health care bill for all Americans.

(Continued on page 2)

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Per Capita State and Local Property Taxes

Number in parentheses indicates standing of states according to burden of state and local property tax. Dollars equals per capita property tax in fiscal year 1984. *(Tax Foundation map)*

(U.S. HEALTH BILL, from page 1)

Since 1965 Federal health spending has grown from 13 percent of the total from public and private funds to nearly 29 percent. State-local spending, in contrast, has remained at around 13 percent of the total throughout the period, according to researchers at the Tax Foundation.

National Health Expenditures by Source of Funds and Type

Selected Calendar Years, 1965-1983[a]

Item	1965	1970	1975	1980	1983
	Amount (millions)				
Total expenditures	$41,749	$74,984	$132,673	$248,013	$355,400
Private expenditures, total	30,950	47,222	76,310	142,170	206,617
Health services and supplies	29,482	44,662	72,975	137,890	199,789
Direct payments	18,522	26,498	38,036	62,477	85,203
Insurance premiums[b]	9,993	16,871	33,178	72,468	110,482
Other	966	1,293	1,761	2,944	4,105
Medical research	176	215	264	313	354
Medical facilities construction	1,292	2,345	3,072	3,967	6,474
Public expenditures, total	10,799	27,762	56,363	105,843	148,783
Health services and supplies	8,754	24,922	51,297	98,200	140,349
OASDHI (Medicare)	—	7,496	16,317	36,819	58,828
Temporary disability insurance[c]	52	66	73	52	58
Workers' compensation	798	1,409	2,432	5,162	6,423
Public assistance medical payments[d]	2,112	6,321	15,098	28,111	37,187
Department of Defense medical care	853	1,782	2,830	4,207	6,589
Maternal and child health programs	255	429	589	810	1,016
Public health activities	814	1,420	3,157	7,711	11,226
Veterans medical care	1,145	1,764	3,495	5,941	7,660
Medical vocational rehabilitation	40	149	224	281	382
State and local hospitals	2,373	3,320	5,230	6,093	7,923
Other[e]	313	767	1,851	3,012	3,057
Medical research	1,340	1,754	3,071	5,110	5,809
Medical facilities construction	705	1,086	1,995	2,532	2,625
	Percentage distribution				
Total expenditures	100.0	100.0	100.0	100.0	100.0
Private	74.1	63.0	57.5	57.3	58.1
Public	25.9	37.0	42.5	42.7	41.9
Federal	13.3	23.6	28.0	28.7	28.9
State-local	12.6	13.4	14.5	14.0	13.0
Exhibit: Total as percent of GNP	6.0	7.6	8.6	9.4	10.8

[a]Data for 1983 are preliminary.
[b]Covers insurance benefits and amount retained by insurance companies for expenses, additions to reserves, and profits.
[c]Includes medical benefits paid under public law by private insurance carriers and self-insurers.
[d]After 1965, primarily Medicaid.
[e]Expenditures for Alcohol, Drug Abuse, and Mental Health Administration; Indian Health Service; school health and other programs.
Source: *Facts and Figures on Government Finance*, 1986, Tax Foundation (forthcoming); basic data from the Department of Health and Human Services, Health Care Financing Administration.

Tax Features

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MARK YOUR CALENDAR

National Taxpayers Conference
on Federal Affairs
May 5 & 6, 1986
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Sessions on: *Living with Gramm-Rudman; Is Unitary Taxation on the Way Out?; Tax Reform Report.*
Special Feature: *The Capitol Steps.*
See March *Tax Features* for details.

Before Medicare and Medicaid, private funds covered about three-fourths of the national health bill. Today they cover less than 60 percent, and more than half of that is met from private insurance payments.

In 1983 Medicare provided benefits of $57 billion for almost twenty million of the thirty million people enrolled in the program, mostly those over 65. This came to approximately $2,900 per patient. (In 1985, Medicare benefits are estimated at $72 billion.) Since 1967, the first year in which Medicare was fully effective, costs of the program have spiraled at an annual growth rate averaging 17 percent, compared to a rate of 13 percent for all national health spending. HCFA projects that Medicare spending will continue to rise rapidly, although the pace will slow somewhat because of recent actions by Washington to reign in explosive spending increases coupled with an anticipated drop in medical inflation rates.

Medicaid, the second largest government health program, serves categories of low-income people. Medicaid served nearly 22 million persons in 1983, at an average cost of $1,500 each. It is financed on an approximately 50-50 basis by the Federal and state-local governments. Total Medicaid expenditures for the program came to $36 billion in 1983 and are estimated at $41 billion for 1985. Medicaid spending has increased at an annual rate of over 13 percent since 1973. Public assistance medical payments (largely under Medicaid) are now about 20 times as large as in 1965.

In addition to public policy changes, Tax Foundation economists cite a number of other factors that pushed health spending upward over the past two decades. These include the aging of the population; a growing population generally; inflation in medical care prices far higher than the general inflation rate; advances in medical technology; greater intensity of health services utilization; rising incomes that increase the affordability of services as compared to commodities; and a variety of other demand and supply factors.

Other large public programs providing health services include: general public health activities of state and local governments (costing $11.2 billion in 1983); state and local hospital care for the needy ($7.9 billion); veterans' medical care ($7.7. billion); and Department of Defense medical care ($6.6 billion).

Ninety-four percent of government spending for health goes for patient care. Medical research and the construction of medical facilities account for about 6 percent of the total, down from 18 percent in 1965.

The accompanying table gives complete breakdown for national health expenditures for select years since 1965.

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FEDERAL TAX POLICY MEMO

Editor: Edward A. Sprague, Vice President–Tax and Economic Affairs

FEBRUARY 1986

Business Tax Burdens—II

Our August 1985 *Federal Tax Policy Memo* on business tax burdens showed a comparison of effective rates of tax for the overall corporate sector over the postwar period. Effective rates of Federal income tax declined from the 1960's onward reflecting the influence of tax relief provisions for business and timing factors. However, when state/local income taxes on corporations and the corporate share of payroll taxes are included in the calculation, the business tax burden rises, both absolutely and in proportion to total corporate profits.

The total corporate tax burden often is not taken into account in public policy considerations. Certainly it wasn't in the formulation of the House tax reform bill last fall. The House Ways and Means Committee quite deliberately went about to impose both higher regular income taxes and a much tougher alternative minimum tax on the corporate sector. A large part of the rationale for the latter was, in the words of the Ways and Means Committee report, "to restrict the ability of corporations to eliminate their tax liability." Reports of low or even negative effective rates of income tax on some corporations or industry sectors figured heavily in the process. The reported examples of corporate tax avoidance didn't have much to do with the overall corporate tax burden but were used to demonstrate the "unfairness" of the present system.

The Ways and Means Committee report also emphasized a need "to restore the traditional balance of the income tax between individuals and corporations." This is a legitimate concern. But it's very difficult to judge just where that balance should be—quite aside from the fact that the real incidence of corporate taxes is always borne by individuals—as shareholders, employees, or customers—not impersonal corporate structures.

What is the corporate "share" of the tax burden? Often it has been expressed by showing how small the Federal corporate income tax contribution to total budget receipts has become—only 9 percent in fiscal 1985 compared to around 30 percent in the 1950's. You see this comparison all the time. But it doesn't mean that much because during the same period Federal payroll taxes have grown so tremendously—from 12 percent to 36 percent of total receipts—which has diminished the importance of all income taxes in the budget picture.

If any comparison of this sort is to be made, it should be limited to income taxes themselves. And, yes, corporate income taxes also have shrunk as a share of total income taxes paid, but not as much and with some special factors affecting the most recent years.

As the table below indicates, there was a precipitous drop-off in corporate income tax receipts, both absolutely and as a percentage of total income taxes in fiscal 1982 and 1983. Corporate receipts fluctuate more widely than individual receipts anyway, and the severe recession of 1981-1982 had its maximum impact on revenues in fiscal 1982 and 1983. This was also the period when the Accelerated Cost Recovery System (ACRS) first took hold. More rapid depreciation, of course, helped depress tax collections initially, although this would tend to be made up in later years—a point consistently ignored in most effective rate analyses.

In the last two fiscal years, corporate income tax receipts jumped to an all-time high—$69.5 billion in fiscal 1985. In fiscal 1986, corporate receipts are expected to be about $76 billion and back up to the 1981 proportion of total income taxes. The revenue recovery coincided with better business conditions and, of course, the implementation of the 1982 and 1984 tax bills, which promptly took back a good part of the tax relief to business offered in 1981.

Federal Corporate Income Tax Receipts
Selected Fiscal Years, 1950-1986

Year	$ Bils.	% of Total Income Tax Receipts
1950	10.4	39.9
1955	17.9	38.3
1960	21.5	34.6
1965	25.5	34.3
1970	32.8	26.6
1971	26.8	23.7
1972	32.2	25.3
1973	36.2	25.9
1974	38.6	24.5
1975	40.6	24.9
1976	41.4	23.9
1977	54.9	25.8
1978	60.0	24.9
1979	65.7	23.2
1980	64.6	20.9
1981	61.1	17.6
1982	49.2	14.2
1983	37.0	11.4
1984	56.9	16.1
1985	69.5	17.3
1986e	76.2	17.5

Sources: Economic Reports of The President.

Corporate Profits and National Income

Critical factors in the "balance" of corporate versus individual taxes are both the level of corporate profits and their share of national income. How you measure corporate profits—with or without adjustments for inflation's impact on inventories and for capital consumption allowances—makes a difference, too. Including inventory and capital consumption adjustments, imperfect as they are, might make more sense for measuring "economic profits." But, for purposes of this exercise, it's more appropriate to exclude them because there is no comparable adjustment to employee compensation, the major element in the personal income component of national income and the individual income tax base.

In any event, corporate profits without these adjustments are now only barely above the level of five years ago, and the trend in corporate profits as a percentage of national income has been irregularly downward since the 1950's. (If the inventory and capital consumption adjustments are included, the trend would be the same only not quite as decisive.) In fact, the downtrend has closely paralleled that of corporate tax

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receipts as a percent of total income taxes.

What, then, do you use as a base for "traditional balance" between corporate and individual taxes? 1960 is probably as good a year as any, when corporate taxes were 34.6 percent of the total and corporate profits, 11.7 percent of national income. This was before the capital recovery liberalizations started in 1961-1962 and before the tax rate cuts of 1964. Corporate profits as a percent of national income for the period 1960-1964 were quite stable, averaging, in fact, 11.8 percent.

In any event, from 1960-1964 to 1985, the corporate profit share of national income dropped by 40 percent, while over virtually the same period, fiscal 1960 to fiscal 1986, corporate tax receipts as a percent of total income taxes dropped 49 percent. Viewed in these terms, we may be really quite close to the "traditional balance" of corporate and individual income tax burdens now despite all the special business tax provisions that some reformers love to rail about. None of this, of course, is an exoneration of the present corporate tax structure, faults of which have been well remarked, but it does certainly raise the question as to why we need to raise business taxes to restore a notion of balance. There is a lot more involved than just a simple proportional division of the current tax burden.

* * * * * * * * *

Total Corporate Profits
Selected Years, 1950-1985

Year	$ Bils.	% of Total National Income[1]
1950	42.9	17.9
1955	49.2	14.6
1960	49.8	11.7
1965	77.4	13.2
1970	76.0	9.1
1971	87.3	9.7
1972	101.5	10.2
1973	127.2	11.3
1974	138.9	11.5
1975	134.8	10.4
1976	170.3	11.8
1977	200.4	12.4
1978	233.5	12.7
1979	257.2	12.6
1980	237.1	10.8
1981	226.5	9.3
1982	169.6	6.7
1983	205.0	7.5
1984	237.6	7.8
1985	227.6	7.1

[1]Reflects revisions to national income accounts as of December 1985.
Sources: Economic Reports of The President.

The Good Government Solution

We have been hearing that the only solution to our budget deficit is a big raise in taxes and that the tax reform measure before the Senate should be the vehicle. These individuals may also call for further spending cuts and/or new nuisance taxes on alcohol or gasoline. But they claim the problem is too large to be handled by spending cuts or tax tinkering alone, and, since the income tax is still the "fairest" revenue source, it should bear the brunt of closing the deficit. The reform bill should be "revenue positive"—to raise $100 billion or so net—instead of revenue neutral. The base broadening ideas of the House, perhaps modified by the Senate, would be incorporated, but the rate reductions would be pared way back or even eliminated. What could be simpler?

Not too many politicians have embraced this wisdom publicly, at least as of this writing. There have been some hints, however. Last summer, in some comments that got little attention at the time, Dan Rostenkowski, the House Ways and Means Committee Chairman, opined: **"When we decide to raise large amounts of revenue to draw down the debt, let's have ready a new tax code that gives us the revenue base to do it without hitting anyone or any business unfairly. If the tax base is broad, a one or two percent hike in the rates can raise a lot of revenue without distorting the marketplace."**

This has a "good government" ring to it, as if out of a textbook on statecraft in public finance. Establish the "fairest" tax base possible, then set the tax rates at whatever level necessary to fund the budget.

The problem is that it isn't anything like what really animated the tax reform effort in the first place. Rate reduction was the tonic that would encourage people and business interests to swallow the pill of base broadening. Sure, it was supposed to lead to a more efficient, even-handed system, too, but it was the incentive of lower rates that would carry the day. In the President's program, this was honed to a sharp edge with a large majority of individual taxpayers scheduled for a net reduction in their income tax burden. It would seem very unlikely that the President, at least, could accept a revenue positive reform program without rate reduction or with only limited rate reduction.

Whatever the Administration or congressional attitude, a revenue positive reform plan loses some of its good government luster rather quickly when put in the context of actual tax policy. The reason taxpayers have clung so tenaciously to various deductions, exclusions, or exemptions is that they didn't trust the rate schedule or political commitments to keep it from rising. Despite ad hoc tax reductions, marginal income tax rates rose steadily higher and became more progressive through the end of the 1970's as inflation moved middle-income taxpayers up the bracket schedule.

Back in 1961, 90 percent of individual returns faced a marginal tax rate of no more than 20-22 percent (the first brackets at that time) with only 10 percent of returns above those rates. By 1979, about half of all returns were taxed at higher marginal rates than in 1961. About 30 percent were taxed at lower rates, mainly because the bottom rate was dropped to 14 percent in 1964. Elsewhere, the move up the bracket ladder was swift. At the 95th percentile, marginal rates increased sharply from 26 percent in 1961 to 38 percent by 1979.

The landmark 1981 Tax Act did cut marginal rates across the board and introduced inflation indexing. If the latter is retained, it will prevent inflationary bracket creep and help restore some confidence in the stability of the tax rate structure. **The 1984-85 tax reform consideration built on this incipient trust with the proposition that work and "economic" investment incentives really would be encouraged if we gave up some of our attachment to deductions, exclusions, exemptions, etc. If, on the other hand, we lose the latter and are rewarded only with tax reformers' sense of "fairness," it could strike a sour note indeed. Despite lofty calls for sacrifice to close the budget deficit gap, it may sound more like the old refrain, "tax and spend, tax and spend."** A separate tax increase on consumption or as a collection of nuisance taxes would not be easy either. But at least this would not break that commitment to a less damaging rate structure.

Facts & Figures Paints U.S. Fiscal Portrait

A variegated picture of the tax, fiscal and economic environment emerges from sampling the latest edition of ***Facts and Figures on Government Finance***. This widely used handbook of public finance statistics offers the most comprehensive collection of data available on government taxes; spending; borrowing; costs of government programs and services; Federal, state and local tax rates; and social insurance costs; along with many important economic indicators.

The fully updated 23rd edition contains 283 statistical tabulations. Among highlights are:

• There are more than 82 thousand units of local government in the United States, including municipalities, townships and towns, school districts, and special districts. Nearly 66 thousand of them levy property taxes. Among states, Illinois has the most local jurisdictions, with nearly 6,500; Pennsylvania is next with close to 5,200 local units.

• Federal, state, and local government spending totaled $10 billion in 1929, less than 10 percent of gross national product (GNP). In calendar year 1984, governments spent nearly $1.3 trillion, or 34 percent of GNP; that was larger than the nation's total output as recently as 1972.

• At the turn of the century, local governments collected more in taxes than the Federal and state governments combined. It was not until World War II that Federal tax receipts exceeded combined state and local receipts. Today Federal taxes account for nearly two-thirds of all taxes; the local share is down to less than 13 percent.

• The population of the United States has grown by nearly 100 million in the last 40 years, while the number of households has increased by 50 million. At the

(Continued on page 4)

"In calendar year 1984, governments spent nearly $1.3 trillion, or 34 percent of GNP."

THE FRONT BURNER

By Robert C. Brown
President
Tax Foundation, Incorporated

"High Noon"

High noon is approaching, and everyone wants to play Gary Cooper. The Administration wants to be the good guy who slays the villain of runaway government spending. The Majority Party in the House wants to be the hero who forces a heartless president to accept defense cutbacks instead of "balancing the budget on the backs of the poor." The Majority Party in the Senate wants to be the great compromiser that drags the other two parties kicking and screaming to the bargaining table.

In fact, if the Washington power elite had their way, there would be no "bad guy" in this drama . . . just an orphaned deficit reduction measure, already repudiated by its putative parents, the U.S. Congress. The only problem is that the villainless melodrama won't wash—either as theatre or as lawmaking.

The Congress that is now screaming like a stuck pig as GRH threatens to bite hard is the same governing body that passed the bill 271 to 154 in the House and 61 to 31 in the Senate, a few short months ago. They passed GRH mostly because they lacked the political courage to reject it and expose themselves to the charge of being soft on spending. Now there are threats of a Coast Guard that can't put to sea and widows and orphans going to bed with empty stomachs. Hogwash. Such posturing serves neither the cause of fiscal responsibility nor the dignity of the U.S. Congress.

The first thing to keep in mind about GRH is that Congress voluntarily passed the legislation. No one held a gun to anyone's head. The only duress was a growing awareness that the voters were getting tired of the Members' inability to act like responsible adults in the area of spending controls.

The second thing to be aware of is that the full weight of GRH will land on the fiscal 1987 budget only if Congress does nothing to implement serious spending reductions before next October 5. Are the weeping and gnashing of teeth emanating from Capitol Hill signs that Congress has already conceded defeat? Having defined the boundaries of the playing field, are our lawmakers now complaining that the field is too small?

There are some who will argue that it is unfair to make Congress the "heavy" in this melodrama. After all, the President has insisted that defense cuts will not be straightjacketed to meet GRH targets. He has refused to allow Social Security to be included in the GRH stewpot. He has remained set in concrete in opposing tax increases.

True enough. But in the end, it must be conceded that the Constitution has placed responsibility at the other end of Pennsylvania Avenue. Only Congress has the power to levy taxes. Only Congress has the power to enact spending legislation. Only Congress contrived and then passed GRH. The White House may propose. But only Congress can dispose. If the deficit reduction act is an evil spawn, we know who its parents are. There are more than enough black hats to go around as the GRH clock ticks relentlessly toward High Noon.

"The first thing to keep in mind about GRH is that Congress voluntarily passed the legislation. No one held a gun to anyone's head."

"On a per capita basis for 1984, Wyoming (with collections of $1,100 per person) and Alaska ($873) far outdistanced any other state."

(STATE-LOCAL PROPERTY TAXES, from page 1)

cent. Per capita property tax revenues grew by 81 percent, from $226 in 1974 to $408 in 1984. During the same period, property tax yields in relation to personal income dropped by 22 percent.

State-by-state per capita property taxes and rankings for 1984 appear on the map on page 1.

Other highlights:

• On a per capita basis for 1984, Wyoming (with collections of $1,100 per person) and Alaska ($873) far outdistanced any other state. The next highest states were New Jersey ($680), Connecticut ($668), New Hampshire ($666), and New York ($650). Alabama ranked lowest in per capita property tax collections ($111), followed by New Mexico ($148), Louisiana ($166), Arkansas ($170), Kentucky ($173), and Mississippi ($189).

• In terms of the decade's percentage growth in per capita property taxes, Alaska and Wyoming also headed the list, followed by the District of Columbia, South Carolina, and Virginia. Altogether, 25 of the 51 jurisdictions reported a doubling or better in per capita property taxes for the decade. None of the states experienced a property tax reduction.

Currently Available

"Working Paper" Series: $3.00 each, Members/$5.00 each, Non-members—includes postage and handling. Order from Publications Department, Tax Foundation, Incorporated, (202) 822-9050.

"Business Tax Burdens/VAT After All? August 1985, 7p.
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"Why Not Tax Amnesty?" September 1985, 5p.
"Tax Treatment of Retirement Savings," December 1985, 22p.
"Gramm-Rudman-Hollings: A Bad Idea Whose Time Has Come," December 1985, 8 p.
"The Uses of a Business Transfer Tax," December 1985, 7 p.
"The House Tax Bill," January, 1986, 15 p.

Summaries of some of these papers may appear as articles in *Tax Features* or in *Federal Tax Policy Memo*.

• Property taxes per $1,000 of state personal income were highest in Wyoming ($92), followed by Montana ($60), New Hampshire ($56), Oregon and Alaska ($53), and Michigan ($52). The lowest property tax burdens in relation to personal income were recorded for Alabama ($12), New Mexico, Delaware and Louisiana (all at $16), Kentucky and Oklahoma ($18), and Arkansas ($19).

• Only seven states and the District of Columbia showed any discernible growth in property taxes compared to personal income during the 1974-1984 period. They were: Alaska (up 64 percent), Wyoming (61 percent), the District of Columbia (33 percent), Michigan (10 percent), South Carolina (9 percent), Iowa (6 percent), and Utah and Oregon (1 percent).

The complete table entitled "Property Tax Collections by State, Per Capita and Per $1,000 of Personal Income for Fiscal Years 1974 and 1984" is available free of charge by contacting the Public Information Department of the Tax Foundation.

Now Available

Facts and Figures on Government Finance—23rd Edition, is now on press and will be available shortly. Priced at $75 ($65 for members), the totally new looseleaf format includes quarterly updates of the statistical data contained in this widely used handbook of public finance. For details, or to order, contact Publications Department, Tax Foundation, Incorporated, One Thomas Circle, N.W., Suite 500, Washington, DC 20005. (202) 822-9050.

(FACTS AND FIGURES, from page 3)

same time, the number of persons occupying each household has dropped from 3.7 to 2.7.

• Per capita general expenditures of U.S. cities in 1983 ranged from an average of $396 in cities with population below 50,000 to $1,388 in cities with 1,000,000 or more.

• The 49 largest cities raised $762 per capita in general revenues from their own sources in 1983. Property taxes brought in $226; general sales taxes, $90; and income taxes, $109—all on a per capita basis.

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TAX FOUNDATION'S VOL. 30, NO. 3 MARCH 1986

TAX·FEATURES

TF Shadow Budget Committee Cautions Against "Euphoric" Budget Outlook

$6,867 Federal Tax Bill For $28K Moderate Earner

The Federal government is spending an estimated $979.9 billion in fiscal year 1986. A moderate-income family—one worker earning $28,000 solely from wages with a spouse and two dependent children—faces a tax bill of $6,867 for fiscal year 1986, according to Tax Foundation economists.

"Income security" costs the most. This comprises social security and Federal employee retirement and disability, unemployment insurance, housing assistance, food and nutrition assistance, and other programs. The total outlay by Uncle Sam will be $318.1 billion. It will cost the $28,000 earner $2,150. In other words, the Federal government will pay out 31 cents for "income security" programs for each $1 this taxpayer sends to Washington.

National defense will cost $265.8 billion—or 26 cents out of each tax dollar. For the moderate-income taxpayer described here, this amounts to $1,797.

Interest on the public debt ranks third—$142.7 billion; for this worker, the tab will be $965, over 14 cents per dollar of taxes.

Health outlays, estimated to total more than $104.3 billion, will cost the moderate-income family $705, or 10 cents for each tax dollar paid.

That's more than 80 percent of all Federal spending for the four largest programs. Other functional programs that will cost the moderate-income taxpayer over $100 in 1986 are: education, training, employment, and social services ($207); transportation ($183); veterans' benefits and services ($180); agriculture ($175); and international affairs ($116). The table on page 4 gives more details.

Another category of major Federal spending that cuts across functional lines as classified in the budget, will preempt nearly half the budget dollar. This is "payments for individuals." In 1986 these payments will add up to $445.9 billion, a cost of $3,124 for the moderate income family, or 46 cents of every tax dollar. This covers the income security items shown above; payments for veterans; assistance to students; health and medical care under medicare and medicaid and other programs; and other payments to individuals under special programs.

Taxes, nontaxes, and borrowing support government programs. The individual income tax provides

(Continued on page 4)

Tax Foundation's Shadow Committee on the Federal Budget called for caution in embracing the recent wave of euphoria over the Federal budget outlook. "This euphoria is based more on changed assumptions than on actual changes in the budgetary policies of the Federal government," the Committee said in a report released March 3.

The strengthening economy, the Committee said, made "achievement of the fiscal 1987 revenue target . . . probable though by no means assured." Committee members found less cause for optimism on the expenditure side of the fiscal 1987 budget, calling the plan "far less plausible than the revenue projection."

The Shadow Committee on the Federal Budget is a citizens' watchdog group operating under the auspices of the Tax Foundation. The Committee monitors Federal budgetary action in a manner similar to the way the Shadow Open Market Committee monitors the actions taken by the Federal Reserve Board with respect to monetary policy.

Leif H. Olsen, former chairman, Economic Policy Committee of Citibank, N.A., chairs the Shadow Committee on the Federal Budget. Other members are The Honorable Harry F. Byrd, Jr., W. Bowman Cutter, Allen Schick, and The Honorable Al Ullman.

The Committee report noted, "The achievement of the fiscal 1988 and later deficit reduction targets will depend on a clock-work falling into place of optimistic economic assumptions and expenditure restraint unprecedented for more than 50 years." Warning of possible efforts to step up spending in the wake of the recovery, the Committee said, "The method used in constructing the baseline assumes that, as revenues grow, Congress and the Administration will not take actions that add to Federal spending. But with a long time span and a buoyant economic forecast, the baseline tends to lull policymakers into believing that they can expand programs without risking higher future deficits." The Committee cautioned against "this type of wishful thinking" pointing out that such an attitude "gave rise to the contemporary deficit crisis, and it is urgent that we not repeat the mistake again."

The report called for "persistent real efforts at fiscal restraint" if the government is "to meet the fiscal 1987 deficit target and approximate the targets for later years."

Leif H. Olsen, who chairs the Shadow Committee on the Federal Budget, served as Chairman, Economic Policy Committee of Citibank, N.A., from 1977-1985.

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State Tax Prospects

General Sales Biggest Tax Source for States

Sales taxes still bring in the most money for the states, according to recent analysis by the Tax Foundation, Incorporated. Economists at the Washington-based tax watchdog organization say that general sales taxes, which are levied by 45 states, brought in $62.6 billion to state treasuries in fiscal year 1984—nearly one-third (31.8 percent) of all state tax collections that year.

Second as a major revenue raiser was the personal income tax, bringing in $58.9 billion in fiscal 1984 for 30.0 percent of total tax receipts. Corporate income taxes, the third largest single tax source, amounted to $15.5 billion, 7.9 percent of the total. Only five states (Nevada, South Dakota, Texas, Washington, and Wyoming) have neither a corporate nor a personal income tax, and only seven states (the previous five plus Alaska and Florida) have no individual income tax.

Each of the 50 states taxes gasoline, which brought in $12.4 billion (6.3%) of their total taxes in fiscal 1984.

All states have local property taxes, and 41 have state property taxes; 39 states have both general sales and income taxes; and 33 states have general sales, income, and property taxes, Tax Foundation economists say.

State Sales Taxes

Connecticut led the list for top rates with its 7.5 percent sales and use tax rate, followed by: Washington (6.5 percent); Minnesota, Mississippi, New Jersey, Pennsylvania, and Rhode Island (6 percent); and Nevada (5.75 percent). No state general sales tax is levied in Alaska, Delaware, Montana, New Hampshire, or Oregon, although municipalities in Alaska do impose sales tax.

The state sales tax is lowest—3 percent—in six states: Colorado, Georgia, Kansas, North Carolina, Virginia, and Wyoming. Localities in 26 states levy sales taxes, generally in addition to those shown in the accompanying table.

(Continued on page 4)

Major Taxes and Rates Used by States
As of January 1, 1986

State	Income taxes: Corporation	Income taxes: Individual	General sales and use tax	Gasoline tax (per gallon)	Cigarette tax (per pack of 20)	Property tax
Alabama	5% (F)	2 to 5% (F)	4%[a]	11¢	16.5¢	X
Arizona	2.5 to 10.5 (F)	2 to 8 (F)	5[a]	16	15	X
Arkansas	1 to 6	1 to 7	4[a]	13.5	21	X
California	9.6	1 to 11	4.75[a]	9	10	X
Colorado	5[b]	3 to 8 (F)	3[a]	12	15	X
Connecticut	11.5[c]	1 to 13[d]	7.5	15[e]	26	X
Georgia	6	1 to 6	3[a]	7.5 + 3% of retail	12	X
Hawaii	5.85 to 6.435	2.25 to 11	4	15 to 18.5	40% wholesale	
Idaho	7.7	2 to 7.5	4	14.5	9.1	X
Illinois	4	2.5	5[a]	12	20	X
Indiana	3[f]	3	5	14.1	10.5	X
Iowa	6 to 12 (F)	.5 to 13 (F)	4	15	26	
Kansas	4.5[g]	2 to 9 (F[h])	3[a]	11	24	X
Kentucky	3 to 7.25	2 to 6 (F[h])	5	10[i]	3.001	X
Louisiana	4 to 8 (F)	2 to 6 (F)	4[a]	16	16	
Maine	3.5 to 8.93	1 to 10	5	14	28	X
Maryland	7	2 to 5	5	13[i]	13	X
Massachusetts	8.33[j]	5[k]	5	11	26	X
Michigan	2.35	5.1[b]	4	15	21	X
Minnesota	6 to 12	1.5 to 14 (F)	6[a]	17	23	X
Mississippi	3 to 5	3 to 5	6	9	18	X
Missouri	5 (F)	1.5 to 6 (F)	4.225[a]	7	13	X
Nebraska	4.75 to 6.65	19% of Federal income tax	3.5[a,e]	17.2	18[e]	X
New Jersey	9[l]	2 to 3.5	6	8	25	X
New Mexico	4.8 to 7.2	.7 to 7.8[m]	3.75[a]	11	12	X
New York	10[c]	2 to 13.5[b]	4[a]	8	21	
North Carolina	6	3 to 7	3[e]	12	2	X
North Dakota	3 to 10.5 (F)	2 to 9[n] (F)	4	13	18	X
Ohio	5.1 to 9.2[c]	.855 to 8.55[b]	5[a]	12	14	X
Oklahoma	5	.5 to 6[m] (F)	3.25[a]	10	18	
Pennsylvania	9.5	2.2	6	12	23.4	X
Rhode Island	8[c]	22.21% of Federal income tax	6	13[i]	23	X
South Carolina	6	2 to 7 (F)	5	13	7	X
Tennessee	6	6[d]	5.5[a]	12	13	
Utah	5	2.25 to 7.75 (F)	4.625[a,b]	14	12	X
Vermont	6 to 9[b]	26.5% of Federal income tax	4[b]	13	17	X
Virginia	6	2 to 5.75	3[a]	11	2.5	X
West Virginia	6 to 7[e]	2.1 to 13	5	10.5	17	X
Wisconsin	7.9	5 to 7.9	5	16	25	X
Florida	5.5	These 7 states have no individual income tax	5[a]	4	21	X
Nevada	These 5 states have no corporate income tax		5.75[a]	11.25	15	X
South Dakota			4[a]	13	23	
Texas			4.125[a]	10	20.5	
Washington			6.5[a]	18	23	X
Wyoming			3[a]	8	8	X
Alaska	1 to 9.4		These 5 states have no general sales tax	8	16	X
Delaware	8.7	1.2 to 9.7 (F)		11	14	
Montana	6.75[m]	2 to 11 (F)		15	16	X
New Hampshire	8.25	5[d]		14	17	X
Oregon	7.5	4 to 10 (F)		11	27	X

(X) Indicates state levies a property tax.
(F) Allows Federal income tax as a deduction.

[a] Local taxes are additional.
[b] Future reduction scheduled under current law.
[c] Alternative methods of calculation may be required.
[d] In Connecticut, New Hampshire, and Tennessee, tax applies to income from intangibles only, at various rates according to type.
[e] Future increases scheduled under current law.
[f] Tax is 3% of adjusted gross income. A supplemental net income tax is imposed at 4%.
[g] A 2-¼% surtax is imposed on taxable income in excess of $25,000.
[h] Deductions limited.
[i] Tax imposed at percent of wholesale value.
[j] Additional 14% surtax is imposed.
[k] Tax of 10% on income derived from intangibles, and 5% on all other income, and an additional 3.75% tax for 1986.
[l] Additional tax on net worth is part of the corporate franchise tax.
[m] Qualified taxpayers may elect to pay alternative taxes at varying rates.
[n] Optional tax of 10.5% of taxpayer's adjusted Federal income tax liability.
Source: Compiled by Tax Foundation from data reported by Commerce Clearing House.

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SPECIAL REPORT

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State Tax and Fiscal Prospects, 1986

By Elsie M. Watters
Vice President-Research
Tax Foundation, Incorporated

Tax issues will be confronted by more than half of the state legislatures holding regular sessions in 1986. Pending legislation, however, stands to have little overall effect on the level of state taxes, because increases contemplated in some states are likely to be offset by reductions elsewhere. Moreover, the states with the most pressing fiscal problems appear generally to be looking more to spending cuts than tax increases to ease budget pressures.

As of early March, a Tax Foundation survey found that 16 states were considering increases in one or more major taxes (sales, income, excises). At the same time, tax reductions were the major issue in at least 6 states, generally those where sizable budget surpluses are projected. In at least 14 states, potential budget deficits in fiscal 1986 were headed off by spending cuts; and in many states, proposed spending increases for fiscal 1987 are either modest or nonexistent.

While the large majority of states are not seeking new revenues in 1986, the finances of most states mirror, to a varying degree, the influence of several forces tending to exert downward pressures on revenues.

(1) Most important among them has been the slowing in the momentum of overall economic growth since 1984, which lowered automatic tax increases below earlier projections and led to "revenue shortfalls." Gross national product (GNP) growth in current dollars slowed from 11.0 percent in 1984 to 5.7 percent in 1985. State tax revenues, which jumped nearly 15 percent in fiscal 1984, rose by less than 9 percent in 1985.

(2) In several states, notably those heavily dependent upon energy resources and agriculture, economic performance fell well below the national average, upsetting financial plans made earlier under more favorable assumptions.

(3) Some substantial tax increases enacted to bolster state receipts during and after the 1981-82 recession have expired or been repealed, and new tax cuts have slowed revenue growth in some states.

(4) In the past five years, Federal grants-in-aid have dropped from 26 percent of state-local general expenditures to 21 percent, and further reductions are expected.

On the spending side also there have been forces at work tending to put pressures on available revenues. Recent state commitments, for example, to "excellence in education" mean that the states are picking up from local governments a larger share of the expanded tab for local schools and other programs in education. Improved road and highway systems are also on the priority list in several states, along with expanded programs for water projects, pollution control, prison reforms, and a host of other purposes.

The states considering tax increases in 1986 include: Alabama, Colorado, Florida, Hawaii, Idaho, Kansas, Louisiana, Missouri, Nebraska, New Mexico, North Carolina, South Dakota, Tennessee, Virginia, Washington, and West Virginia. Aggregate increases, if all proposals were approved, could yield about $1.5 billion in new annual revenues. Slightly over half of that ($850 million) would represent higher sales taxes in 7 states. The remainder ($650 million) would be in the form of higher cigarette levies (3 states) and motor fuels taxes (8 states).

Besides these major tax proposals, some states appear to be examining all possible sources of new revenues. The approaches include: cutting down on general sales tax exemptions; eliminating the once-popular subsidies for ethanol (gasohol) sales; imposing taxes on smokeless tobacco where it is not now taxed; amnesty programs to recover unpaid taxes; new forms of legalized gambling—lotteries, casinos, and parimutuels; and giving local governments a freer rein in raising taxes for themselves.

On the other hand, either the governors or legislative leaders (or both) are calling for tax reductions in Connecticut, Delaware, Michigan (a $360 million income tax reduction has already been enacted this year), New York, Pennsylvania, and Rhode Island. The reductions, largely in income or sales taxes, total around $1.5 billion, about the same size as the proposed hikes in other states.

While not aimed at revenue reduction, legislative consideration of changes in methods of taxing the income of multinational corporations could, if enacted, lead to between $300-and-$400 million in additional tax reductions. California, Idaho, New Hampshire, and Utah are considering limiting the scope of these taxes to a "water's-edge" basis.

No regular legislative sessions are scheduled in 1986 in Arkansas, Montana, Nevada, Oregon, and Texas.

Selected State Reports

Alabama. The governor has proposed a tax increase plan to buffer the effects of Federal cutbacks on aid to the poor; he

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would raise taxes on cigarettes, beer, and other items for new revenues of $51.8 million annually. To provide more funds for highway construction, he also proposed eliminating the 3-cents-a-gallon excise tax reduction for gasohol.

Alaska. Falling oil prices will force legislators to look at "all facets" of state taxation of oil-related industries, since about nine-tenths of state revenues are derived from such sources. Although a balanced budget is expected for the "foreseeable future," the price of oil is an important factor. The legislature may also ask the voters to express their views on whether the state should reimpose a personal income tax (the previous tax was repealed in 1979).

Arizona. The governor recommended a $15 million income tax credit for child and dependent care expenses for working couples. Several proposals would give counties new funding, including authorizing voters to override property tax limits. Voters will be asked to increase the constitutional limit on total spending for schools.

California. The legislature is considering proposals to repeal the state's worldwide unitary approach to corporate income taxation, in favor of a "water's-edge basis," which means that multinational corporations would be taxed only on their income produced in the United States. A similar move was defeated in 1985, and chances of approval this year are regarded as slim. Legislators are also discussing possible revisions in the structure of the personal income tax that would broaden the base and lower rates. The governor's proposed spending budget is in dispute because legislative officials claim that it overstates the amount the state can spend under the Gann constitutional limit set by voter initiative in 1979. The measure requires that revenues above the limit must be returned to taxpayers.

Colorado. The governor recommended increasing the cigarette tax by 8 cents a pack, capping the investment tax credit at $1,000, and raising motor fuels taxes. Legislative leaders are also considering asking for a hike from 3 percent to 4 percent in the state sales tax.

Connecticut. For the third straight year the state faces a budget surplus. The governor proposes to use it to increase spending by about 11 percent, including a $100 million increase in aid to education. Senate leaders want additional tax cuts of about $100 million (in 1985 taxes were cut by $155 million a year), to which the governor is opposed.

Delaware. The governor recommended tax relief for the business community and for individual taxpayers, totaling $10.5 million over the second half of fiscal 1987. He would cut public utility and gross receipts taxes and lower personal income taxes by 4 percent across the board (if approved, this would be the third straight year for an income tax cut).

Florida. A newly enacted state comprehensive plan calls for funding many additional services and infrastructure "wants and needs." With an eye to increasing revenues, the legislature is expected to review the coverage of the sales tax and to consider eliminating various exemptions, many of which are scheduled to sunset in 1987. Lawmakers may also raise cigarette taxes and authorize local governments to levy new taxes, such as a gross receipts tax on business.

Georgia. Stating that the educational reform program enacted in the last session "is being hailed across the country as the most all-inclusive effort yet undertaken by any state," the governor proposed that over 64 percent of all new, non-earmarked funds in the budget be used for education, thus accelerating increases in school spending.

Hawaii. The governor proposed a tax package to increase the general sales tax rate, partly offset by increases in personal exemptions under the income tax. It is estimated that the plan would raise an additional $20 million a year, to be earmarked for visitor promotion. The legislature offered a counterproposal that would raise the money by increasing the tax on hotels and rentals.

Idaho. The governor recommended broadening the sales tax base to include certain services, "major modifications" in the unitary tax law (adopting a water's-edge method of reporting corporate income for tax purposes), and liberalizing local government authority to levy local option sales and income taxes. Other proposals before the legislature include increased personal income and sales taxes.

Illinois. The legislature may try again to double-weight the sales factor in the corporate income allocation formula. (Currently sales, property, and payrolls receive equal weight in determining the amount of taxable income assignable to each state in which a company does business.) Both houses passed such a bill last year, but the governor vetoed it.

Indiana. The legislature failed to approve bills that would have continued the sales tax exemption for gasohol and prevented state taxation of an Indiana-based corporation's overseas income.

Iowa. Saying that the state "has the worst agricultural crisis since the great depression," the governor called upon the legislature to "streamline government and avoid tax increases." His proposed fiscal 1987 budget would hold spending at the same level as in 1986. Under study in the legislature are proposals to change the structure of the state income tax by limiting the deductibility of Federal taxes.

Kansas. The governor recommended an increase in the sales tax from 3 percent to 4 percent to raise an estimated $190 million in new revenue for 1987, along with liberalization of the food sales tax refund program for lower income persons. New revenues are said to be needed to restore the state general fund balance, for economic development efforts, highway improvements, education, and to assist counties with financing property reappraisal.

Kentucky. The governor's budget message noted that the economy of the state is growing steadily, with revenue matching or exceeding estimates, and that the budget outlook is far better than in the past eight years.

Louisiana. The state confronts a revenue shortfall of $150 million in fiscal 1986, due in part to falling oil prices. The governor estimates that about $800 million more will be needed in 1987 to finance (and expand) current programs and

National Taxpayers Conference on Federal Fiscal Affairs

May 5 & 6, 1986
Loew's L'Enfant Plaza Hotel, Washington, D.C.

Monday, May 5th

11:00 a.m.-12:00 Noon — **Registration**

12:00 Noon-2:00 p.m. — **Luncheon**

Chairman: Robert C. Brown, President, Tax Foundation, Incorporated

Speaker: The Honorable Ernest F. Hollings, U.S. Senator from South Carolina
Second Ranking Minority Member, Senate Budget Committee

2:00-5:00 p.m. — **Afternoon Session**

"The Federal Budget with or without Gramm-Rudman-Hollings"

Chairman: Douglas P. Bates, Special Assistant to the President, Tax Foundation, Incorporated

Speakers: Leif H. Olsen, Chairman, Tax Foundation Shadow Committee on the Budget
Former Senior Vice President and Chief Economist, Citibank, N.A.

Peter Davis, Vice President, Prudential-Bache Securities
Former Tax Economist, Senate Budget Committee

"Interstate Taxation: Is Federal Legislation Coming?"

Chairman: Melvin Morris, Executive Director, Arizona Tax Research Association
Chairman, National Taxpayers Conference

Speakers: **Administration View**
George N. Carlson, Director, Office of Tax Analysis
U.S. Treasury Department

Business View
William R. Brown, President, Council of State Chambers of Commerce

State View
Basil Wisner, Chief Deputy Controller, State of Maryland
1986 President, National Association of Tax Administrators

6:00-9:30 p.m. — **Reception and Dinner**

Feature: An Evening with the *Capitol Steps*
(A musical review of Washington politics, especially budget foibles)

(Continued on following page)

Reservation Form—National Taxpayers Conference on Federal Fiscal Affairs
May 5 & 6, 1986 ■ L'Enfant Plaza Hotel ■ Washington, D.C.

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National Taxpayers Conference Program (continued)

Tuesday, May 6th

8:30-9:30 a.m.		**Breakfast**
		"The Administration Tax Program"
	Chairman:	Edward A. Sprague, Senior Vice President-Program Planning and Tax Policy Tax Foundation, Incorporated
	Speaker:	The Honorable J. Roger Mentz, Assistant Secretary for Tax Policy U.S. Treasury Department
9:30 a.m.-12:00 Noon		**Morning Session**
	Chairman:	Edward A. Sprague, Senior Vice President-Program Planning and Tax Policy Tax Foundation, Incorporated
		"Senate Consideration of Tax Reform"
	Speaker:	William Diefenderfer, Chief of Staff, Senate Finance Committee (Invited)
		"Business Tax Provisions and Alternatives"
	Speakers:	Byrle M. Abbin, Managing Director, Office of Federal Tax Services Arthur Andersen & Co.
		Emil R. Sunley, Director of Tax Analysis, Deloitte, Haskins & Sells
		"Tax Amnesty Programs"
	Speaker:	Ira A. Jackson, Massachusetts Revenue Commissioner, Commonwealth of Massachusetts
12:00 Noon-2:00 p.m.		**Luncheon**
	Chairman:	Jared E. Hazleton, President, Texas Research League
	Speaker:	The Honorable William V. Roth, Jr., U.S. Senator from Delaware Third Ranking Majority Member, Senate Finance Committee

* * * * * * *

to provide pay increases for teachers and state employees. The governor's proposals to introduce three forms of legalized gambling—lotteries, casino and cruise ship gambling—to bail the state out of its financial problems met with considerable opposition. Although some legislators are proposing tax increases (e.g., a state property tax) to finance education reforms previously enacted, further tax increases are regarded as unlikely. This is due largely to adverse public reaction to increases enacted two years ago, when the legislature enacted a 25 percent hike in state taxes.

Maine. The governor is proposing a plan to eliminate some tax "loopholes" that would result in changes in sales, insurance, inheritance, and nonresident personal income taxes. A proposal before the legislature would phase out the 5 percent sales tax on energy purchased for use in manufacturing production processes.

Maryland. No significant tax changes are expected in 1986. Bills before the legislature would impose a tax on smokeless tobacco and authorize local sales taxes.

Massachusetts. The major tax issue will be an initiative petition for a state tax limit, holding growth in taxes to the average increase in the state's wage and salary income for the three preceding calendar years. Despite tax reductions last year, prospects for future budget years are said to be favorable. Pressure is expected to come from local governments as Federal cutbacks occur.

Michigan. The personal income tax rate of 5.1 percent was scheduled to drop back to its pre-1983 rate of 4.6 percent on October 1, 1987. Legislation has been approved to accelerate the scheduled drop (which will save taxpayers $360 million a year) to March 31, 1986. Fiscal 1987 is regarded as "a tight budget year," and the governor's budget calls for $11 million less than in 1986.

Minnesota. Following tax cuts totaling over $400 million a year approved by the 1985 legislature, the state faced a shortfall of $736 million for the current biennium. To avoid an impending deficit, the governor proposed $380 million in budget cuts (about 3.7 percent of spending), together with use of most of the budget reserve. The governor also urged repeal of a 1985 law that would automatically suspend indexing of the personal income tax if the budget shortfall exceeds the amount set aside in the reserve fund.

Mississippi. The electorate may have an opportunity to vote on a new constitutional amendment submitted by the legislature that would ease property tax burdens on homeowners, while raising taxes on commercial property, motor vehicles, and utilities. Both legislative leaders and the governor have indicated that they want no increase in taxes. Budget cuts have been made because of revenue shortfalls (due in part to inaccurate estimates of the effects of certain tax increases approved last year). Because of commitments to spend more for education, the governor proposes 9 percent cuts in many state programs, along with diversion of some highway funds to general operation.

Missouri. Local groups are seeking a one-half of one percent increase in the state sales tax (for $150 million annually), coupled with state aid to cities to replace cutbacks in Federal grants. In response to Federal legislation in 1985, the legislature is considering a measure to exempt food-stamp purchases from sales tax; the estimated revenue loss to the state is $12 million annually. Other issues result from the sizable shifts in property tax burdens caused by statewide assessments completed in 1985.

Nebraska. The state continues to face tight budget problems because of its sluggish economy. If tax receipts continue to lag behind projections, the legislature may consider one of several alternatives: first, raising the income tax from 19 percent of Federal tax liability to 20 percent; second, raising the sales tax from 3½ percent to 4 percent; or, third, levying a sales tax on services. A bill to authorize a statewide ticket lottery is said to be getting much attention.

New Hampshire. The governor proposed no tax increases and criticized "some individual legislators," who want to increase spending, of misunderstanding "the difference between needs and wants." He also asked the legislature to end the "snack tax," by exempting snacks such as candy bars from the 7.5 percent rooms and meals tax. The legislature is working on a proposal, strongly favored by the governor, to change the state's worldwide unitary tax on the income of multinational corporations to a "water's-edge" basis.

New Jersey. Noting that prior legislative action will save taxpayers about $555 million in fiscal year 1987, the governor called for a 3 percent increase in state spending, the smallest rise in more than a decade.

New Mexico. The governor asked for an additional $225 million in new revenues next year to improve education and serve other purposes. A compromise plan for education, worked out by the governor and legislative leaders, would raise state school spending by only about half of what the governor requested. The legislature approved a $150 tax increase measure that would raise personal income and gross receipts taxes. Other bills before the legislature would raise cigarette taxes, increase motor fuels taxes, and impose a tax on tobacco products that are not now subject to tax.

New York. The governor's financial plan foresees a $166 million excess of receipts over disbursements in fiscal 1987. Republican state senate leaders are calling for reductions in sales, personal income, and corporate income taxes totaling $3.9 billion over five years. The governor is said to oppose further tax reductions; the legislature and the governor approved tax cuts last year totaling more than $3 billion over a three-year period, mostly in personal income taxes.

North Carolina. At a budget session convening in June, the legislature may consider raising gasoline tax rates by 3 cents a gallon.

Ohio. The state's finances are reported to be "in good shape," after significant tax cuts in 1985. Several bills concerning local taxes are before the legislature, as well as a measure to impose an excise tax on tobacco products.

Oklahoma. Heavily dependent upon oil and gas activity,

the state's economy is weak, and state revenues from energy resources have fallen sharply. The governor's budget calls for spending 9 percent less in fiscal 1987 than in the current year; and additional spending cutbacks may be imposed.

Oregon. No legislative session is scheduled for 1986. A citizen's group is seeking an initiative that would cut property taxes and raise individual income taxes instead. The outlook for approval of the measure is uncertain, since four such initiatives have previously been turned down by the voters.

Pennsylvania. Following significant income tax reductions last year, the governor called for further cuts in both personal and business taxes. He proposed cutting the personal income tax rate from 2.2 percent to 2.1 percent (the lowest in eight years), reducing the corporate net income tax from 9.5 percent to 8.5 percent (the lowest in eighteen years, according to the governor), and cutting the capital stock and franchise tax. If approved, the annual reduction would be $237 million; it would follow 1985 cutbacks in personal and corporate income taxes estimated at $185 million a year. The governor also recommended that state spending growth be below the inflation rate.

Rhode Island. The governor advocated property tax relief for elderly homeowners. Bills in the legislature would lower the personal income tax and the state sales tax.

South Carolina. To avoid a $46 million deficit in fiscal 1986, the state has cut most agency budgets by 2 percent. Legislation has been introduced to authorize local option taxes.

South Dakota. The legislature is considering increases in motor fuels and special fuels excise taxes from 13 cents to 14 cents a gallon, as well as a new tax on tobacco products.

Tennessee. The governor asked for a $1.2 billion, ten-year, road-building program, to be financed by an increase in the gasoline tax from 12 cents to 15 cents a gallon. Because of the prospective ending of Federal general revenue sharing, the legislature may consider removing the cap on local sales taxes. The change would raise about $120 million annually for localities. (Present law applies local sales tax only to the first $1,100 of the purchase price of a single article of personal property.)

Texas. No regular session will be held in 1986. Concerns about state finances have heightened with the sharp decline in oil prices; the state is said to lose $100 million in annual revenues for every $1 a barrel drop in oil prices. In mid-February the state comptroller estimated a $1.3 billion deficit for the biennium that began September 1, 1985. Shortly afterward, the governor issued an official executive order cutting spending by 13 percent for the two-year period. The size of the cut would vary by type of services, and exempt items would include local schools and highway construction and maintenance.

Utah. Adhering to his pledge when elected a year ago, the governor asked for no tax increases in 1986. He has indicated, however, that new revenue sources will be needed next year to support programs in education. A proposal in the legislature would cut state-mandated property taxes for local school support and make up the shortfall by raising state taxes on individual and business incomes. An initiative petition to limit property taxes is circulating for the November 1986 ballot. The legislature approved a measure replacing the state's worldwide unitary approach for taxing corporate income to a "water's-edge" approach that allows taxation only of a firm's U.S. income. The bill's sponsors expressed hope that new business attracted to the state by the reform would make up for any revenue losses. (Last year, use of the "water's-edge" method was approved administratively.)

Vermont. The governor proposed modest state tax increases to finance a property tax homestead credit for homeowners with family incomes of $32,000 or less. The credit would be financed by a new franchise tax on cable television, withdrawal of the income tax exemption on out-of-state tax-exempt bonds, and the elimination of loss carrybacks from personal and corporate income taxes.

Virginia. The legislature increased the gasoline tax 1.6 cents a gallon as part of a $50 million highway improvement plan. The governor has said he will call a special legislative session in September to address highway finance issues, especially speeding up highway construction.

Washington. The governor's fiscal plan includes increases of 8 cents a pack on cigarettes and 16.75 percent on tobacco products, with proceeds earmarked for Puget Sound water pollution control. The budget adopted last year for the 1985-87 biennium will result in a $136.8 million reserve, according to current forecasts. The governor has proposed additional supplemental expenditures.

West Virginia. The governor proposed no new taxes and presented the legislature with a budget that was in deficit by $8.5 million. The constitution does not require the governor to submit a balanced budget, but it does require the legislature to enact one. The new state lottery is said to be a "wild card" and could produce a few million dollars over the estimate. The legislature may consider a casino gambling law, as well as raising the gasoline tax.

Wisconsin. In a special session of the legislature called by the governor in late January, the legislature adopted a $340 million "budget repair" package, containing spending, revenue, and surplus adjustments, to bring the 1985-87 budget back into balance. The package is said to conform to the governor's stated principles for dealing with the budget gap—no increase in state taxes, no accounting gimmicks, an ending balance of at least $75 million, spending cuts deep enough to ensure flexibility in shaping the budget for the next biennium, and budget adjustments which "spread the pain" evenly.

Wyoming. Although falling oil prices have sharply reduced the state's projected revenues (Wyoming gets nearly half its state tax revenue from the severance tax), no major fiscal problems are foreseen. The proposed spending budget has been cut, and the state has a $100 million-plus "rainy day" reserve account.

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Some 283 statistical tabulations make the 23rd edition of *Facts and Figures on Government Finance* a mosaic of Federal, state, and local public finance. Gross debt, trends in taxes and spending, annual rates of major economic indicators, and a host of other data offer a composite view of where the nation is from a fiscal perspective and how it got there. Among highlights of the latest edition of the widely regarded handbook on public finance are:

• During the years from 1954 through 1963, married couples with two dependents earning $35,000 a year paid $9,037 in Federal income taxes on average; by 1984, the tax was down to $5,070; singles at the same income level with no dependents paid tax of $13,778 in 1954-1963, compared to $7,065 in 1984.

• Enrollment in public elementary and secondary schools peaked at just over 46 million pupils in school year 1971, after rising by some 20 million in the previous two decades; it is estimated at 39 million in 1986 and at 42 million in 1993.

• Federal, state and local expenditures in 1984 were equal to $6,128 for every man, woman, and child in the nation. The Federal government spent 64 percent of the total.

• Gross debt of all U.S. governments amounted to $8,779 per capita in 1984; over 75 percent of that was owed by the Federal government.

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THE FRONT BURNER

By Robert C. Brown, President
Tax Foundation, Incorporated

"Rustles of Springtime"

Spring is the season of hope. And hope has come to Washington. Of all places, hope has bloomed amid the thorns of the budget debate.

It must be official. *The New York Times* has reported that economists, the gloomiest of social scientists, have detected a falling trend in the Federal deficit. Not just government economists, mind you, who are paid to notice that sort of thing for whoever is in power at any given point in time; but private sector pundits who are presumably committed to a more objective reading of the fiscal tea leaves.

When the gloomy science starts smiling, we lesser mortals had better watch out. Things are seldom what they seem—especially in economics and even more especially in the economics of public finance.

There is a story about a group of travelers who fall into a pit. One is an engineer, one is a physicist, and one is an economist. The engineer says he can't do anything to extricate the trio, because there are no structural materials to build scaffolding. The physicist says he can't help out his comrades, because there is no energy source available to use to transform matter into motion.

The economist reassures them. He has the solution. "Assume we have a ladder. . . ," he says.

The optimists in the ranks of economic forecasters may be assuming we have a ladder, I'm afraid. At best, we have solved a hypothetical deficit with hypothetical deficit reduction measures.

No one knows if Gramm-Rudman-Hollings will be found unconstitutional, much less if Congress will choose to follow its stringent disciplines. Congress certainly managed to ignore the Byrd amendment, passed in 1978, which flat-out obliged the House and the Senate to pass a budget that was in balance, beginning in FY 1981.

Also, the free fall in the dollar may accelerate, causing a financial crisis that will worsen the deficit situation. Interest rates may stop falling; unemployment may rise; the farm credit system could collapse; any number of budget busting developments could occur.

So, at the risk of sounding dismal, we feel a note of caution must be raised. Perhaps the winter of our fiscal discontent is indeed ending. But one budgetary swallow, does not constitute a deficit reduction spring.

Stay on guard!

(FEDERAL TAX BILL, from page 1)

the lion's share—$2,354 from annual earnings for this $28,000-a-year family. Social security taxes funnel another $2,002 to Washington.

However, direct levies account for only about three-fifths of the Federal tax take, according to Tax Foundation analysts. To these must be added such indirect taxes as employer's share of social security taxes; corporate income taxes; excise taxes on such items as gasoline, liquor and tobacco; and miscellaneous levies. These will take another $2,511 from the moderate earner's paycheck.

Altogether, direct and indirect Federal taxes claim almost 25 percent of this family's annual income. But even that does not tell the whole story.

After paying a big slice of current earnings for taxes, the family must assume its $1,848 share of the $202.8 billion fiscal 1986 deficit. All told, current Federal taxes and borrowing add up to $8,715, or 31 percent of this moderate-income family's earnings.

How the Federal Government Will Spend A Worker's Tax Dollars in Fiscal 1986[a]

Function	Worker's share: Amount	Worker's share: Percent of total	Total spending (millions)
Income security[b]	$2,150	31.32	$318,146
National defense	1,797	26.17	265,827
Net interest	965	14.05	142,740
Health[c]	705	10.27	104,330
Education, training, employment, and social services	207	3.02	30,671
Transportation	183	2.67	27,106
Veterans' benefits and services	180	2.62	26,619
Agriculture	175	2.55	25,871
International affairs	116	1.69	17,141
Natural resources and environment	87	1.27	12,905
General science, space, and technology	60	.87	8,899
Community and regional development	54	.78	7,922
Administration of justice	46	.67	6,788
General government	42	.62	6,270
General purpose fiscal assistance	42	.61	6,236
Energy	30	.44	4,433
Commerce and housing credit	26	.37	3,802
Total[d]	$6,867	100.00	$979,928
Exhibit: Payments for individuals	$3,124	45.5	$445,861

[a] In this example, the worker is the sole source of support for a spouse and two dependent children, and earns $28,000 per year.
[b] Includes social security, Federal employee retirement, unemployment compensation, housing assistance, food and nutrition assistance; excludes veterans' income security.
[c] Includes medicare, medicaid, and others; excludes veterans' hospital and medical care.
[d] After deducting $35,776 million in undistributed offsetting receipts not classified by function.
Source: Tax Foundation computations, based on Federal Budget presented February 5, 1986 (Office of Management and Budget) and tax laws from Treasury Department.

(SHADOW BUDGET COMMITTEE, from page 1)

He is a Director of The Interpublic Group of Companies; Trustee, Atlantic Mutual Insurance Company; Director, Centennial Insurance Company; and a member of the Advisory Council of the Tax Foundation and of the Panel of Economic Advisers to the Congressional Budget Office.

The Honorable Harry F. Byrd, Jr., represented Virginia in the United States Senate from 1965 to 1982. During his Senate career, he served on the Committee on Finance (1969-1982), Senate Armed Services Committee, and Joint Committee on Taxation. Senator Byrd is also a Trustee of the Tax Foundation.

W. Bowman Cutter, a Partner in the accounting firm of Coopers and Lybrand, was Executive Associate Director for Budget, Office of Management and Budget, from 1977 to 1981.

Allen Schick is Professor, School of Public Affairs, The University of Maryland. He was previously Senior Specialist, Congressional Research Service.

Single copies of the 18-page report, "Achievability of Fiscal 1987 Budget Targets," are available from the Tax Foundation Public Information Department at no charge.

(STATE TAX RATES, from page 2)

Individual Rates

Minnesota (14 percent); New York (13.5 percent); Connecticut (on a limited base), Iowa, and West Virginia (13 percent) had the highest marginal individual income tax rates. The rate schedules are progressive (i.e., rise as income brackets go up) in all but five states. Illinois, Indiana, Massachusetts, Michigan, and Pennsylvania apply a flat rate, regardless of income level. In three states, income taxes are levied as a percentage of Federal individual income tax obligations—Nebraska, Rhode Island, and Vermont.

The maximum corporate income tax rates are highest in Iowa and Minnesota (12 percent); Connecticut (11.5 percent); Arizona and North Dakota (10.5 percent); and New York (10 percent).

Gasoline Tax

Gasoline taxes were highest in Washington (18 cents); Nebraska (17.2 cents); Minnesota (17 cents), Arizona, Louisiana, and Wisconsin (16 cents); Connecticut, Michigan, and Montana (15 cents); and Hawaii (where combined state-local rates range from 15 to 18.5 cents per gallon). Florida (4 cents); Missouri (7 cents); Alaska, New Jersey, New York, and Wyoming (8 cents) place the lowest levies on gasoline. The motor fuels taxes in Georgia, Kentucky, Maryland, and Rhode Island are levied at specific percentages of the wholesale or retail selling price of the product. In addition, some states also tax motor fuels under the states' general sales tax.

Cigarette Tax

Cigarette taxes also make a notable contribution to state tax revenues, Tax Foundation economists report. In fiscal 1984, the states collected $4.1 billion, 2.1 percent of their total taxes, from tobacco products excises.

The table on page 2 gives further details, as of January 1, 1986, for major taxes and rates prevailing in the states.

Erratum

Page one of the January 1986 *Federal Tax Policy Memo* (entitled "The House Tax Bill") contained a discussion of the marginal rate structure under HR 3838. It was stated erroneously that married taxpayers with $43,000-$49,000 in taxable income would face a two point increase in their marginal rate from 33% to 35%. This did not take into account the changed definition of taxable income that would result from the proposed switch back to the standard deduction and taking the zero bracket amount out of the rate tables. There still would be such a marginal notch problem, but it would affect a smaller group—more precisely, in the case of joint returns, those with $46,700—$49,400 in taxable income at 1986 levels.

R9050-3

TAX FOUNDATION'S VOL. 30, NO. 4 APRIL 1986

TAX·FEATURES

Tax Freedom Day is May 1

Tax Bite From 8-Hour Pay Of Average U.S. Worker Is 2 Hours, 39 Minutes

The bad news is that taxes will take a 2-hour, 39-minute bite from the average worker's 8-hour earnings in 1986. The good news is that's the same size bite taxes took last year, according to economists at the Tax Foundation.

Federal taxes will claim, as they did in 1985, one hour and 44 minutes of a worker's earnings, while state-local taxes preempt 55 minutes' worth of productive labor. The total tax bite from the workday is far ahead of the next most costly item, housing and household operation, which will require a worker to put in 1 hour and 26 minutes on the job, a minute less than in 1985. Third come food and tobacco, which will consume an hour's worth of work, the same time span as last year, according to Foundation analysis.

Researchers at the Washington-based tax watchdog organization detect only minor shifts in the allocation of a day's pay over the last 12 months. Earning the money for the clothing budget will require 18 minutes on the job, 1 minute less than 1985, as will covering medical expenses (37 minutes in 1986 vs. 38 minutes in 1985).

The largest growth was in the area of miscellaneous costs, a catch-all category comprising personal care, personal business, private education, religious

(Continued on page 4)

Tax Freedom Day

Selected Years 1930-1986

Year	Tax Freedom Day
1930	February 13
1940	March 8
1950	April 3
1960	April 17
1970	April 28
1975	April 28
1980[a]	May 1
1981[a]	May 4
1982[a]	May 3
1983[a]	April 30
1984[a]	April 28
1985[a]	May 1
1986[b]	May 1

[a] Revised. [b] Forecast.

May 1 is Tax Freedom Day 1986. This means it takes from January 1 through April 30 to earn the money to pay the average American's tax bill, assuming every dollar in the paycheck is allocated for Federal, state and local government taxes.

Economists at the Tax Foundation annually calculate Tax Freedom Day as a way of showing the size and weight of government on the economy. Since 1984, the date has moved three days later in the calendar—from April 28 to May 1. (Revisions based on updated government data show that Tax Freedom Day, 1985, also fell on May 1, a day later than originally estimated.)

Is the taxpayer losing ground, since the day when the burden of taxation symbolically lifted from his shoulders is once again slipping further into the year? To some extent, yes, according to Tax Foundation analysts.

When the passage of the Economic Recovery Tax Act of 1981 (ERTA) stopped the on-going rise of Federal taxes, Uncle Sam's tax take dropped slightly relative to income (time worked) until 1985, when it rose again. Taxes are estimated at about the same ratio to working time in 1986 as in 1985, but still that is below 1981.

(ERTA cuts were, of course, diminished by subsequent Congressional take-backs of business tax cuts in 1982 and 1984, higher excise taxes on gasoline and cigarettes, and hikes in payroll taxes instituted to restore the troubled social security system to solvency.)

However, all that was gained under ERTA has not yet been lost. Before that landmark tax reduction measure, Tax Freedom Day fell on May 4 (1981), and the American worker had to put in 124 days on the job to cover tax liabilities. Today, 121 days in harness covers a worker's taxes.

On the other hand, state-local taxes have generally risen faster than incomes over the past six years, taking up any potential "leisure time" that taxpayers may otherwise have enjoyed from Federal cuts. The net result appears to be that we are back where we started in 1980—a May 1 date for Tax Freedom Day.

To some extent, the average taxpayer is also a victim of the economy's successful recovery. Tax collections have risen along with the rising economy and growing incomes of Americans, Foundation researchers point out, causing the flow of revenues to Federal, state and local treasuries to increase as well.

The May 1 date for Tax Freedom Day marks the third time in the 1980s that this landmark day for the tax-

(Continued on page 3)

THIS ISSUE:

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Tax Freedom Day
Tax Bite

PAGE 2:
Federal Tax Burden

PAGE 3:
Tax Freedom Day Origin
Tax Amnesty

INSERT:
Excises/ Amnesty

'86 Federal Tax Burden Tops $752 Billion; CA, NY, and TX Lead the 50 States

For all the talk of austerity in Washington, Uncle Sam's take from the taxpayer continues to grow ever larger. Federal taxes will hit $752.2 billion in the current fiscal year (1986), according to economists at the Tax Foundation. The Administration's 1987 budget as presented on February 5 projects an increase of $42.8 billion (6.0 percent) over the $709.4 billion collected in taxes in 1985. The overall rise mirrors annual increases of $19 billion in individual income taxes, nearly $10 billion in corporate income taxes, and over $17 billion in social security levies, offset somewhat by projected reductions in miscellaneous taxes.

Federal tax revenues for fiscal 1987 are projected to climb by another $70.2 billion (9.3 percent) over 1986 levels. Again in 1987, individual income taxes will be the biggest factor in the rise, going up another $32 billion, followed by a $21 billion hike in social security taxes and $16 billion in corporate tax bills. This tax burden falls unevenly among the states as the following breakdown shows.

Estimated Total and Per Capita Federal Tax Burdens by State
Fiscal Years 1985-1987

State	Total burden (millions)			Per capita burden			State rank 1986	
	1985	1986	1987	1985	1986	1987	Total	Per Capita
TOTAL	$709,400	$752,178	$822,386	$2,982	$3,133	$3,395	—	—
Alabama	8,996	9,526	10,400	2,234	2,344	2,536	24	45
Alaska	2,355	2,489	2,711	4,676	4,907	5,306	44	1
Arizona	8,271	8,789	9,631	2,590	2,632	2,758	27	35
Arkansas	5,011	5,308	5,800	2,148	2,230	2,388	32	48
California	86,183	91,441	100,028	3,324	3,485	3,767	1	9
Colorado	10,178	10,799	11,815	3,115	3,214	3,420	23	14
Connecticut	13,282	14,097	15,429	4,215	4,478	4,906	17	3
Delaware	1,994	2,113	2,309	3,239	3,416	3,715	47	10
Florida	33,177	35,271	38,696	2,927	3,013	3,201	6	23
Georgia	15,395	16,343	17,884	2,613	2,748	2,979	12	34
Hawaii	2,974	3,158	3,457	2,819	2,949	3,179	40	25
Idaho	2,179	2,308	2,522	2,108	2,162	2,288	45	50
Illinois	38,475	40,746	44,494	3,343	3,541	3,867	4	8
Indiana	14,915	15,822	17,309	2,698	2,847	3,098	15	32
Iowa	8,078	8,566	9,372	2,765	2,919	3,181	28	27
Kansas	7,480	7,936	8,686	3,063	3,244	3,545	29	13
Kentucky	8,502	9,004	9,834	2,250	2,347	2,525	26	44
Louisiana	11,522	12,199	13,320	2,685	2,786	2,981	22	33
Maine	2,752	2,916	3,186	2,356	2,471	2,673	42	43
Maryland	15,193	16,119	17,626	3,475	3,667	3,988	14	6
Massachusetts	20,451	21,690	23,717	3,537	3,761	4,124	10	5
Michigan	26,213	27,728	30,239	2,872	3,020	3,275	9	21
Minnesota	12,487	13,249	14,493	2,977	3,135	3,403	20	17
Mississippi	4,948	5,243	5,730	1,885	1,978	2,139	33	51
Missouri	14,124	14,988	16,409	2,814	2,979	3,254	16	24
Montana	2,046	2,171	2,376	2,452	2,570	2,777	46	38
Nebraska	4,433	4,711	5,166	2,751	2,913	3,183	34	28
Nevada	3,005	3,180	3,470	3,119	3,121	3,219	39	18
New Hampshire	3,142	3,338	3,656	3,135	3,247	3,465	38	12
New Jersey	29,802	31,583	34,504	3,966	4,203	4,592	8	4
New Mexico	3,409	3,617	3,960	2,364	2,477	2,677	37	42
New York	59,251	62,877	68,795	3,383	3,635	4,027	2	7
North Carolina	15,225	16,138	17,631	2,450	2,576	2,791	13	37
North Dakota	1,889	2,001	2,186	2,759	2,928	3,205	48	26
Ohio	30,657	32,466	35,457	2,851	3,019	3,296	7	22
Oklahoma	9,101	9,657	10,569	2,732	2,870	3,110	24	29
Oregon	7,047	7,460	8,157	2,542	2,598	2,738	31	36
Pennsylvania	34,297	36,283	39,581	2,889	3,064	3,351	5	20
Rhode Island	2,896	3,067	3,346	3,016	3,200	3,497	41	15
South Carolina	7,391	7,842	8,574	2,212	2,317	2,501	30	46
South Dakota	1,641	1,745	1,915	2,329	2,481	2,728	49	41
Tennessee	11,605	12,294	13,427	2,431	2,544	2,745	21	39
Texas	50,557	53,626	58,666	3,115	3,255	3,507	3	11
Utah	3,669	3,886	4,243	2,145	2,193	2,311	36	49
Vermont	1,286	1,363	1,490	2,394	2,503	2,699	51	40
Virginia	17,305	18,368	20,101	3,042	3,199	3,468	11	16
Washington	13,232	14,023	15,326	2,972	3,075	3,283	18	19
West Virginia	4,183	4,428	4,833	2,128	2,236	2,424	35	47
Wisconsin	13,153	13,918	15,185	2,735	2,868	3,101	19	30
Wyoming	1,537	1,627	1,776	2,854	2,865	2,968	50	31
District of Columbia	2,506	2,657	2,904	4,170	4,582	5,193	43	2

Source: U.S. total taxes as shown in the Federal budget submitted February 1986; computations of total and per capita tax burdens by state were made by Tax Foundation.

Highest Burdens

As they have almost every year in recent decades, California, New York, and Texas hold the questionable honor of carrying the largest Federal tax burdens in the nation. Total dollar amounts collected in Federal taxes tend to be highest in the most populous states, explain Tax Foundation analysts.

Just ten states will send almost 58 percent of all revenue collected in Washington, even though they have less than 54 percent of the population. These "top ten" account for $433.7 billion of all Federal taxes. Ranked in descending order, they are:

CA	$91.4 billion
NY	$62.9 billion
TX	$53.6 billion
IL	$40.7 billion
PA	$36.3 billion
FL	$35.3 billion
OH	$32.5 billion
NJ	$31.6 billion
MI	$27.7 billion
MA	$21.7 billion

Lowest Burdens

Sharply contrasting with this huge tax load is the burden borne by the lowest ten. With 3 percent of the population, the following states will also

(Continued on page 4)

Tax Features

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FEDERAL TAX POLICY MEMO

Editor: Edward A. Sprague, Vice President–Tax and Economic Affairs APRIL 1986

Excises, Amnesty, and Fiscal Foibles

The Senate is being dragged reluctantly but without too much screaming and kicking to adoption of several revenue "enhancers" to flesh out the tax reform plan and/or reduce the deficit.

As for reform, the President's insistence on a 35% top rate and a full $2,000 exemption for middle-incomers set off a scramble for new money to keep the measure revenue neutral, on paper anyway. But most of what is politically acceptable in the way of base broadening is already spoken for in the House version (H.R. 3838). Some other ideas—such as amortizing part of advertising expense or disallowing part of business interest deductions—were floated and promptly sank. Thus, the Chairman of the Finance Committee, Bob Packwood, in setting up his Chairman's mark, was forced to turn *back* to limitations on state/local tax deductions and *out* to a new revenue source as the principal ways to balance the package. ***Raising the excise tax take, for the first time in the reform effort, would go outside of what could be considered "tax reform" options, and to some extent even outside of the income tax structure itself, to pick up significant new revenues.***

Actually, most of the estimated $75 billion revenue increase from excise sources over five years would come from corporate and individual income tax payments after disallowing the business deduction for Federal excise taxes and tariffs paid. Apparently, however, additional tax would be imposed whether or not the excises have been taken into income and deducted. Businesses that thought they were acting only as collection agents, such as airlines and telephone companies, also would be hit by the new impost.

There isn't any real "reform" rationale here. It's a simple money grab, as are the companion proposals to price index the alcohol, tobacco, and motor fuels excises and to raise the wine excise. The President, of course, has stated quite emphatically that the only kind of tax increase he will countenance is one that helps balance tax reform. And these excise tax proposals would seem to fit in that category.

Deficit Euphoria

Meanwhile, back at the deficit reduction game, the Senate Budget Committee, much more willing to entertain tax increases than the President, is looking at various measures, including a Federal tax amnesty, to help meet the Gramm-Rudman-Hollings deficit targets for fiscal 1987 and afterwards. This is taking place amidst much more optimistic assumptions about the size of the deficit problem. According to both OMB and CBO estimates, Congress may need to come up with as little as $30 billion in deficit reduction actions to achieve, on paper, the fiscal 1987 Gramm-Rudman-Hollings deficit target. (That target is $144 billion, but there is a $10 billion leeway before the automatic "sequestration" process is triggered.) A more conservative defense spending outlook, falling oil prices and interest rates, and a buoyant general economy have combined to produce an almost euphoric sense of improvement in the budget outlook regardless of the fate of the Gramm-Rudman-Hollings initiative. In its first report, the Tax Foundation's *Shadow Committee on the Federal Budget* explicitly warned that this euphoria was based on changed *assumptions* rather than actual changes in budget policy and that achievement of the fiscal 1988 and later deficit reduction targets would "depend on a clock-work falling into place of optimistic economic assumptions and expenditure restraint unprecedented for more than 50 years."

Congress, however, operates mainly on a pretty short time frame—November 1986 in particular—and in dealing with the fiscal 1987 budget, the problem does look a lot more manageable than a few months ago. Concurrently, talk of a major new revenue source, such as the business transfer tax or a big-bucks energy tax, has died down. ***If more humdrum tinkering with the system—excise tax increases, Federal tax amnesty, perhaps some user fees from the President's budget proposals—can do the job, why get bogged down in major controversy over value-added or energy taxation?*** And if such tinkering could raise, say, $15 billion in new money for fiscal 1987, it could go almost halfway toward meeting the deficit target without closing the Library of Congress, shutting down the Coast Guard, and some other politically frightening things that are said to happen if the Gramm-Rudman-Hollings target must be accomplished through expenditure cuts alone. Or so the thinking goes, anyway.

Policy Issues in Excise Taxation

It's somewhat ironic that tax reform should be trying to raise excise taxes, directly or indirectly. One may recall that a capstone of tax policy in the 1960's was to abolish a good number of the then selective Federal excises including manufacturers' excises on appliances and automobiles, retail excises on jewelry and furs, "document" taxes on securities, and even an excise on playing cards. This was done to help stimulate the economy and because it was felt that such taxes were inherently discriminatory and inappropriate as part of a broad-based tax system. Some excises lingered on to dress up the budget and, in the case of alcohol and cigarette taxes, because they were easy targets. We also added a couple of new ones during the energy crunch of the late 1970's—the gas-guzzler tax and the "windfall" profits tax on oil and gas. Currently, of the *nondedicated* excises—that is, those not deposited in trust funds for specific purposes—only the alcohol, tobacco, windfall profits, and telephone usage taxes provide significant Federal revenue. All the rest of the nondedicated collections amounted to only $400 million in fiscal 1985 and no single excise was over $150 million. (Tax policy trivia question: What

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time-honored weapons still yield $8 million in Federal excise revenues? See answer below at *.)

The following table indicates the change in Federal dependence on excise taxes since many selective excises were repealed in 1965.

Excise Taxes in the Federal Budget
Fiscal 1965 and 1985
($ mils.)

	1965	1985
Budget or Federal Funds		
Alcohol	3,773	5,562
Tobacco	2,149	4,779
Manufacturers' excises	2,870	100
Retailers' excises	513	—
"Windfall" profits on oil & gas	—	6,396
Miscellaneous	1,718	2,320
Total	10,911[1]	19,097
% of total receipts	9.1%	2.6%
Trust Funds		
Highway fund	3,659	13,015
Airport and airway fund	—	2,851
Other	—	1,028
Total	3,659	16,894
% of total receipts	3.1%	2.3%
Total Excises	14,570	35,992
% of Total receipts	12.2%	4.9%

[1] Total is net of refunds which were not distributed by category for fiscal 1965 budget funds.
Sources: Budgets of the U.S. Government, FY 1967 and FY 1987.

Obviously, the importance of excises in the overall budget picture has gone down considerably. In fact, if the so-called "windfall" profits tax on oil and gas—which resulted from the special circumstances of the 1970's price controls—is not included in the 1985 list, Federal funds excises would have accounted for only 1.7 percent of total receipts. In the trust fund or dedicated use category, the highway trust fund is very important for financing the Interstate and other Federal highway programs. This is our principal user tax program—conceptually quite different from the Federal funds excises. Otherwise, the only really significant excises now are, in descending order of their revenue impact: alcohol, tobacco, dedicated airport excises, and telephone service. The superfund for cleaning up the environment may join the category if Congress ever agrees on how to extend it.

Alcohol and tobacco excises present a particular problem for policy directions. Even before the states take their share, these are stiff levies on individual products. Some would justify the high rates of tax because of social opprobrium attached to their use. But can you frown on product consumption and still depend on it as a reliable revenue source? Together the alcohol and tobacco taxes brought in $10.3 billion in fiscal 1985, 54 percent of nondedicated excise tax receipts and 29 percent of total excises. Even in today's megabuck budget, this is not an insignificant amount. If, for purposes of tax reform or deficit reduction, Federal excises were made nondeductible for business and either indexing applied to, or effective rates raised for, alcohol, tobacco, and motor fuels, it would accentuate this policy dilemma.

Besides the distillers, brewers, vintners, and tobacco companies, other selected industries, such as trucking, airlines, and petroleum, could be hard hit by the Finance Committee draft proposal. In some cases, the added cost probably would be passed on to consumers. But this would depend on market conditions. Business, i.e., shareholders and employees, undoubtedly would have to bear a good portion of the added burden. This is why the Joint Committee on Taxation is unable to distribute the incidence of the proposed excise boost between individuals and business taxpayers. Furthermore, new taxes on motor fuels, whether for reform or deficit reduction, could reopen the old argument about diversion of dedicated funds—what should go in the trust fund to support the highway program, what goes to the general fund, and why the difference?

In any event, the impact of increased excise taxation, either through increased tax rates or nondeductibility of taxes paid, would be uneven and arbitrary across the economy. And that is the basic reason why tax policy has looked askance at selected excises. ***There really is no policy justification for not allowing a legitimate trade or business to deduct what are clearly business expenses, and possibly substantial ones. The fact that individuals cannot take Federal excise taxes as itemized personal income tax deductions is irrelevant. By the logic of the draft proposal in the Finance Committee, employers' payroll taxes would not be deductible either, as individual employees cannot deduct their social security contributions. No, we are not suggesting a new revenue enhancer, just pointing out the policy confusion.***

Congress may well decide to accept a little more confusion if it will provide a money plug for reform or deficit reduction. It wouldn't be the first time. Admittedly, the other choices are not all that attractive, but it is still very difficult to make a silk policy while biting the ears of selected excises.

Federal Tax Amnesty—Gimmick or Godsend?

If the Feds could pick up a quick $10 billion or more at minimal administrative cost and without raising anyone's taxes, who wouldn't jump at the chance? Well, the IRS Commissioner for one, who is still dead set against Federal tax amnesty. But others in Congress seem to be cozying up to the idea. It's likely to find a home within the Budget Committees' recommendations for deficit reduction.

As noted in our working paper of September 10, 1985, "Why Not Tax Amnesty?," a number of states have conducted successful tax amnesty programs, some of them far more successful in terms of initial revenue collections than had been anticipated. While details of the programs have differed, the typical pattern has been to offer tax delinquents and nonfilers a "one-time" chance to pay up without penalties or criminal prosecution. Payment of all back taxes and usually interest thereon has been required and those with civil or criminal cases for state tax violations pending have been excluded from amnesty.

The following table from our September paper, updated to include the recent New York State amnesty, shows the initial results of five programs in industrial states, all with significant income tax structures.

In conjunction with their amnesties all five states stepped up enforcement programs such as intensified auditing, stiffer reporting requirements, and larger penalties for noncompliance. These were publicized widely, concurrent with

* bows and arrows

the amnesty period, as the "carrot and stick" approach. Massachusetts, for example, conducted a high visibility campaign about both its amnesty and new enforcement measures. The state attributed a large revenue pickup in fiscal 1984—beyond the direct results of amnesty for back taxes and beyond what could be expected from economic growth—to this campaign. The administrative cost of the amnesty program itself was said to run somewhat over $1 million.

Selected State Tax Amnesty Receipts

State	Period	Total Receipts ($ mils)	Income Tax Related Receipts ($ mils)	Income Tax Related Receipts as % of Total Income Tax Revenues[1]
California	Dec 1984-Feb 1985	144	103	0.8%
Illinois	Oct-Nov 1984	154	121	3.4%
Massachusetts	Aug-Oct 1984	85	52	1.5%
Minnesota	Aug-Oct 1984	12	9	0.3%
New York	Nov 1985-Jan 1986	360	209	1.8%

[1]Fiscal 1984, except fiscal 1985 for New York.
Sources: State Taxpayer Research Organizations and Tax Foundation, Incorporated, *Facts and Figures on Government Finance—1986*.

Suppose we did run a national tax amnesty along the lines proposed by Rep. Brian Donnelly (D-MA). His bill, H.R. 2530, would provide a one-time, three-month amnesty based on the Massachusetts experience, coupled with more IRS enforcement powers and hiring of an additional 7,500 enforcement personnel. Disregarding administrative cost and the possible application of such a program to social security, estate and gift, and Federal excise taxes, what would be the potential revenue consequence for income taxes—based solely on the states' experience? The unweighted average of the five state programs listed above was 1.6 percent of their existing revenues. If applied to fiscal 1985 Federal income tax receipts, personal and corporate, that would yield about $6 billion, only a fairly small portion of which could be considered a permanent addition to the revenue base.

Much higher—and lower—numbers have been bandied around. The Senate Budget Committee estimated a range of $7-$25 billion over three years. The Joint Committee on Taxation isn't sure Federal amnesty would raise any net revenue at all. Nobody has a real handle on it. Commissioner Egger of the IRS claims that, over the long term, amnesty could be a net revenue loser, because heretofore honest taxpayers would resent it and let their own compliance slip. He also claims that the Federal collection process is much more sophisticated than any of the states and that many taxpayers who took advantage of state amnesty programs have been paying their proper Federal income taxes right along. All of the states conducting amnesties have agreed to provide the IRS with information on their tax delinquents. It's not known how widely publicized this was, but it does lend some credence to the Commissioner's point.

Recently, the revenue director of one of the above-mentioned states told this writer that amnesty, especially any amnesty with interest forgiveness, was simply discounting the state's receivables. He inferred that his state's "successful" amnesty was mainly a publicity stunt, that the state would have collected the money anyway without giving the wrong signals to the rest of the taxpayer population. This reflects the professional tax collector's disdain for programs that, by their existence, are indictments of the system's ability to function as designed. ***Not too long ago, of course, the IRS itself was extremely reluctant to admit that there was any significant tax evasion problem and to attach any numbers to it. Now, it is readily conceded that we have uncollected taxes in the legal economic sector on the order of $100 billion—a lot of it probably beyond the reach of regular compliance measures no matter how sophisticated. This does not mean that the IRS isn't trying. It just has been overwhelmed by some of the institutional changes in the economy and society.***

Again, in Massachusetts, it was reported that approximately one-third of the 47,000 amnesty participants were nonfilers, some never having filed a state income tax return. While this doesn't say much for the previous state of tax administration in Massachusetts, it does point to some potential long-term gains if those previous nonfilers can be kept on the rolls. Even if a much smaller proportion of nonfilers or nonparticipants were drawn into the Federal system as a result of amnesty, it could have positive effects well beyond the fiscal year in question.

If a national amnesty is to be seriously considered, its use as a revenue plug for fiscal 1987 should be downgraded. More logically, it should be looked at in conjunction with tax reform stressing simplicity and fairness, at least in the individual sector. The "carrot and stick" would seem to work best with a fresh start on the system. There is no guarantee, of course, that the current reform campaign will fulfill that condition.

* * * * * * *

The Chairman's Mark—Other Features

While the excise tax proposals have grabbed the headlines, tax observers have been digging frantically into the 221-page spread sheet containing Chairman Packwood's detailed recommendations to the Finance Committee. They are finding: (a) most of the President's priorities, (b) a lot of the House bill, and (c) some interesting variations. Overall, the Chairman has put together an acrobatic repertory, loosely stitching together all sorts of competing pressures. Whether it would really prove revenue neutral remains to be seen.

As markup already has started, and numerous changes can be expected before this piece appears in print, we shall go light on analysis, touching only on some highlights.

For individuals, the proposed rate structure is more to the President's liking with a top rate of 35 percent, cutting in at a

significantly higher level of taxable income than under the House bill. Upper-income individuals are not necessarily cheering, however, because:

(a) their personal exemption would be phased out over $100,000 in adjusted gross income;

(b) most itemized deductions would be limited to the first two brackets of 15 and 25 percent;

(c) a severe limit on consumer interest deductions; and

(d) in a major break from past proposals, all tax-exempt interest would be considered a preference item under the alternative minimum tax. On announcement, the last-mentioned little wrinkle just about shut down the municipal bond market. It's likely to be dropped or revised substantially.

The most significant itemized deduction affected by (b) immediately above would be for state income taxes, which would seem to be a poor vehicle for income redistribution. But the companion proposal to eliminate deductibility of state sales and personal property taxes entirely is likely to cause an even bigger ruckus.

It was expected that the Chairman would go lighter on employee benefits and retirement income provisions than the House. In some respects, his provisions here are more liberal, but many were taken wholesale from the House bill, and there are stiffer proposed requirements for qualified pension plan coverage, vesting, etc., in line with Senator Heinz's legislation.

Overall, the individual tax changes would reduce income tax liabilities by about the same amount as the House bill, with slightly more going to the low end and slightly less to the high end of the income classification. Upper-income groups would face considerable new complexities in tax compliance.

Business, of course, still shoulders the brunt of increased tax burdens under the Packwood plan. Depending on how you split the excise tax provisions, it bears a little more, or a little less, than under the House bill. No one really expected a major change here.

Capital-intensive industries should be happier with Chairman Packwood's more liberal capital recovery proposal and the investment credit refund. The whole corporate sector would benefit from a 35 percent top rate compared to 36 percent under the House bill. And the foreign income provisions look a little better from the business community view, too.

Cutting the other way, in addition to the excise proposals, are stiffer treatment of banks and insurance companies, dropping entirely the dividend paid deduction, and, quite likely, a much more severe corporate alternative minimum tax. Even with a lower rate than the House bill—20 percent as against 25 percent—the addition of tax-exempt interest and 50 percent of book income over the minimum tax base as preference items could subject many companies to quite substantial minimum tax liability. This also could hit companies in mining, timber, and oil and gas, provisions for which were attacked directly by the House but not by Chairman Packwood's program.

All in all, a mixed bag, which faces severe tests in Committee and on the Senate floor. Stay tuned.

* * * * * * *

Business Tax Burdens—III
The Vanishing Tax Cut From 1981

No question that part of the business bashing in the current reform campaign is in reaction to repeated charges that the corporate income tax virtually was eliminated by the Economic Recovery Tax Act of 1981 (ERTA). This was a vast overstatement, even right after ERTA, and seems pretty silly in relation to what has happened since and what has been proposed in the way of reform. Yet, we keep hearing reference to the great corporate giveaway of 1981 as a rationale for increasing business tax burdens.

Just to help set the record, we reproduce figures from the fiscal 1987 budget document, which are quite instructive in this regard.

Lest anyone accuse the Administration of fudging them, the Joint Committee on Taxation has indicated the same type of results.

Effect of Major Enacted Legislation From 1981 Through 1985 on Corporate Income Tax Receipts, 1985-1989
($ bils.)

	1985	1986	1987	1988	1989
Economic Recovery Tax Act of 1981	-32.0	-43.4	-51.6	-54.9	-56.2
Tax Equity and Fiscal Responsibility Act of 1982	19.2	30.3	39.7	42.8	42.6
Highway Revenue Act of 1982	-0.2	-0.2	-0.2	-0.2	-0.2
Deficit Reduction Act of 1984	3.3	5.8	8.1	9.7	10.6
Net Effect[1]	**-12.1**	**-10.5**	**- 7.4**	**- 5.2**	**- 4.2**
Addendum					
Net Effect of Period Legislation on Individual Income Taxes	-114.9	-133.5	-156.1	-178.1	-202.9

[1] Individual acts do not sum exactly to net effect because of interaction effects.
Source: Budget of the U.S. Government, FY 1987.

Businessman Launched Tax Freedom Day in '48

Tax Freedom Day is thirty-eight years old this year. Dallas L. Hostetler, Executive Director of the Florida State Retailers Association, originated the notion of a Tax Freedom Holiday in 1948. His idea marks the first day of the year in which American taxpayers started working for themselves, instead of for the funding of Federal, state, and local government.

Hostetler's efforts soon gained widespread attention. In 1950, a Concurrent Resolution of the U.S. House of Representatives and Senate concluded by resolving the "Tax Freedom Holiday be symbolized as a day of relief throughout the land, with such demonstrations as may seem appropriate, including prayer for deliverance." In 1953, Hostetler received the Freedoms Foundation's George Washington Honor Medal Award.

In 1974 Hostetler contacted the Tax Foundation and asked the non-profit tax watchdog organization to carry on his effort to highlight the true size of the tax burden. "At age 72," he wrote, "I must forego the annual promotion of this observance. In the interest of perpetuating the idea, I would like to turn it over, without obligation, to some nationally known and highly respected tax organization. Obviously, I thought first of your Tax Foundation, Inc."

Tax Foundation had already highlighted Tax Freedom Day in its own materials and had been computing, since 1953, the size of the tax bite from the average person's eight-hour workday (see accompanying article). Foundation analysts were delighted to accept Hostetler's offer of the concept, which he had registered with the U.S. Copyright Office in 1953. It has proven to be one of the most widely reported pieces of research issued by the Tax Foundation each year.

(**TAX FREEDOM DAY,** *from page 1)*

payer has coincided with May Day, an interesting convergence in view of the international acceptance of that term as a distress call.

The table on page 1 documents the date for Tax Freedom Day for selected years.

THE FRONT BURNER

By Robert C. Brown, President Tax Foundation, Incorporated

"Amnesty for Tax Cheats?"

Nothing is so powerful as an idea whose time has come—especially when it purports to bring in between $8 and $20 billion to Federal coffers. The idea is tax amnesty, already implemented with surprising success by some 18 states, to the tune of about $800 million.

However, what's sauce for the states is not necessarily sauce for the Federal gander. There are problems with tax amnesty:

Fairness. Does amnesty for tax cheats makes patsys of those who have paid their fair share—plus the scofflaws' share—all along?

Reinforcement of negative behavior. Having been forgiven once, will tax cheats expect to be forgiven again—perhaps every five years or so?

Optimistic revenue projections. Federal tax collections have always been much more stringent than states' policing of their revenue systems. How much collectible revenue is actually escaping the IRS?

Estimates are squishy. The Senate Budget Committee staff forecasts $11.7 billion over three years. The Senate Finance Committee Chairman foresees a windfall between $12 and $20 billion over three years. The IRS and the Joint Committee on Taxation refuse to forecast.

A case is also made that, once tax cheats are introduced back into the tax collection mainstream, most will stay there.

What to do?

For openers, let's have a full and free discussion. When a proposal with such far-reaching consequences surfaces, we must make certain the legislative process remains fully deliberative.

Second, if we do do it, Uncle Sam must promote the concept with all the fervor used to sell bonds during World War II. Amnesty won't just happen. It must be made to happen.

Next, make certain—and obvious—that enforcement will be beefed up.

Finally, any tax delinquents who do return to the fold should be kept on a separate tracking system—permanently. In essence, they are on parole.

Any scheme that promises to increase Federal revenues and bring tax dodgers back to the fold ought to be looked at. Before it becomes policy, it ought to be given a second—very close—look by all parties involved.

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(FEDERAL TAX BURDEN, *from page 2)*

bear 3 percent of the Federal tax burden ($21.4 billion) in fiscal year 1986:

ME	$2.9 billion
DC	$2.7 billion
AK	$2.5 billion
ID	$2.3 billion
MT	$2.2 billion
DE	$2.1 billion
ND	$2.0 billion
SD	$1.7 billion
WY	$1.6 billion
VT	$1.4 billion

Per Capita Burdens

Per capita tax burdens, by contrast, tend to hit hardest in states with relatively high average income levels. In fiscal year 1986, residents in the ten states with the highest per capita tax burdens will pay approximately 38.0 percent of the tax bill, about $286.3 billion. Their average Federal tax burden will be $3,684, about 18 percent higher than the national average of $3,133. Citizens in the ten states with the lowest per capita tax burdens will pay $54.1 billion, or 7.2 percent of the total. Their average tax burden works out to $2,421 per person, about 23 percent below the national average.

"Top Per Capita"		"Bottom Per Capita"	
AK	$4,907	NM	$2,477
DC	$4,582	ME	$2,471
CT	$4,478	KY	$2,347
NJ	$4,203	AL	$2,344
MA	$3,761	SC	$2,317
MD	$3,667	WV	$2,236
NY	$3,635	AR	$2,230
IL	$3,541	UT	$2,193
CA	$3,485	ID	$2,162
DE	$3,416	MS	$1,978

Tax Bite in the Eight-Hour Day and Tax Freedom Day 1980-1986[a]

Item	1980	1981	1982	1983	1984	1985	1986[c]
Taxes	2:39	2:43	2:41	2:38	2:36	2:39	2:39
Federal	1:48	1:52	1:48	1:43	1:42	1:44	1:44
State and local	:51	:51	:53	:54	:54	:55	:55
Food and tobacco	1:03	1:01	1:04	1:03	1:04	1:00	1:00
Housing and household operation	1:24	1:23	1:30	1:29	1:31	1:27	1:26
Clothing	:19	:18	:19	:19	:19	:19	:18
Transportation	:41	:40	:40	:41	:43	:41	:41
Medical care	:32	:33	:37	:38	:39	:38	:37
Recreation	:20	:19	:21	:21	:22	:21	:21
All other[b]	1:02	1:03	:48	:51	:46	:55	:58
Tax Freedom Day:	**May 1**	**May 4**	**May 3**	**April 30**	**April 28**	**May 1**	**May 1**

[a]Data reflect recent benchmark revisions in national income and product accounts.
[b]Includes personal care, personal business, private education and research, religious and welfare activities, net foreign travel, and net savings.
[c]Forecast.
Source: Tax Foundation, derived from data supplied by U.S. Department of Commerce, Bureau of Economic Analysis.

Tax Foundation's Formula

Tax Foundation's formula is designed to show where Federal tax burdens actually fall, rather than where taxes are collected. By contrast, U.S. Treasury figures show where taxes are collected, but do not purport to provide a picture of the state-by-state impact of Federal taxation.

An example of how the two methodologies differ appears in comparison of data related to the collection of Federal excise taxes on tobacco products. Treasury data show these taxes as collected mainly in a few southern states. However, the burden of these taxes may be assumed to fall on consumers of these products in all states, so that collections data do not show who is actually bearing the burden of these taxes.

The table on page 2 provides further details.

(TAX BITE, *from page 1)*

and welfare activities, net foreign travel, and net savings. These items will require 3 more minutes' work this year than they did last.

The total tax burden per 8-hour day for 1986 is exactly the same as it was in 1980. The landmark tax cuts of the 1981 Economic Recovery Tax Act of 1981 (ERTA) caused a drop in the Federal portion of the tax burden, lessening the work time required to cover taxes in 1982, 1983, and 1984. Last year, the cycle had come full course, as subsequent increases in Federal business and payroll taxes eroded some of the gains under ERTA, and as the total tax take increased apace of the economic rebound.

The accompanying table gives full details for taxes and other major cost areas, broken down as a portion of the typical 8-hour workday from 1980 to the present.

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TAX FOUNDATION'S VOL. 30, NO. 5 MAY 1986

TAX·FEATURES

Congress Now Costs Taxpayers Almost $2 Billion Per Year

While Gramm-Rudman-Hollings with its mandatory spending cuts hangs in the balance, Congress is planning to spend heavily on its own activities, according to recent analysis by the Tax Foundation. The budget for the Legislative Branch may increase as much as 21 percent in fiscal year 1986.

The President's budget for fiscal 1986 estimates that Congress and other Legislative Branch agencies will cost taxpayers $1.9 billion—an increase of $336 million over the $1.6 billion spent last year. Looking back ten years, Tax Foundation economists say that the 1986 budget for Congress is two and a half times what was spent on the Legislative Branch as recently as 1976, and more than eight times 1966 levels.

Ten years ago, the Tax Foundation first raised the prospect of Congress becoming "The Next Billion Dollar Bureaucracy," as a study published at that time labeled the Legislative Branch. Prediction became reality within two years, when Federal outlays for Congress broke the $1 billion mark in 1978. If current trends continue, Congress will become a $2 billion bureaucracy within the next two years, Foundation economists say.

Outlays for Congress alone will approach $922 million

(Continued on page 4)

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Federal Aid

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Minimum Tax/ Tax Reform

Outlays for the Legislative Branch of the Federal Government by Unit Selected Fiscal Years 1966-1986[a]
(Thousands)

Unit	1966	1976	1985	1986
Total	$231,505	$775,366	$1,609,511	$1,945,652
Congress, total	111,865	374,122	824,582	921,977
Senate	35,388	123,851	264,662	297,311
House of Representatives	68,095	197,525	462,677	472,389
Joint activities	8,382	52,746	97,243	152,277
Legislative agencies, total	119,640	401,244	784,929	1,023,675
Architect of the Capitol	26,158	57,281	107,306	169,670
Botanic Garden	497	1,235	1,983	2,331
Congressional Budget Office	—	2,763	16,056	18,058
General Accounting Office	46,136	131,778	289,751	278,957
Government Printing Office	21,662	93,391	70,487	93,868
Library of Congress	25,187	117,193	277,326	432,354
Office of Technology Assessment	—	5,035	15,889	14,589
U.S. Tax Court	—	6,919	18,881	25,850
Other	—	1,447	1,000	2,867
Deductions for offsetting receipts	—	-15,798	-13,750	-14,869

[a]Data for 1986 are estimates from the *Budget* presented in February 1986.
Source: Office of Management and Budget.

Federal Aid No Bargain; Average Cost of $1 in Aid To Twenty States—$1.19

State and local governments received $99.6 billion in Federal grants-in-aid during fiscal year 1985, an increase of $6.9 billion or 7.4 percent over the previous year, according to Tax Foundation economists.

This increase was largely attributable to substantial hikes in grants for medicaid and for highway and housing programs, they said, and was the largest in recent years. It followed a period during which Federal budget restraints sharply mitigated growth in Federal aid. As compared to annual increases averaging 15 percent during the 1970s, Federal aid since 1980 has been held to an annual average increase of just over 2 percent.

There were 328 different programs in 1985, down from 361 in 1981. The five largest are medicaid, highways, Aid to Families with Dependent Children, housing, and general revenue sharing for local governments. Together, they account for almost 53 percent of the grants disbursed, a total of $52.6 billion in 1985.

"Paying States"

While the following state-by-state analysis deals with the $99.6 billion in Federal tax costs of these programs, Tax Foundation analysts point out that this is only two-thirds of the full costs of the programs. State and local taxpayers put up another $49 billion in matching funds as a condition of receiving the grants. Total Federal, state, and local costs of the grant programs were $149 billion.

Residents of 20 states, whose Federal tax burdens exceeded the amount of grants received by their state and local governments, footed most of the bill for the grant programs going to all 50 states and the District of Columbia.

The 138 million persons residing in these "paying" states bore 61 percent of the costs—$60.9 billion to support the programs, while their state and local governments received less than $51 billion in Federal grants-in-aid. The average tax "cost" per dollar of Federal aid was $1.19.

"Receiving States"

On the other hand, the 100 million residents of the

(Continued on page 2)

(*GRANTS-IN-AID, from page 1*)

remaining 30 states and the District of Columbia paid an average of 80 cents in Federal taxes for a dollar of Federal grants. These "receiving" states sent $38.7 billion in taxes to Washington and received back $48.6 billion worth of Federal aid.

For the fifth year in a row, Texans paid the highest tax premium for Federal grants. Each dollar of grants cost Texans $1.59 in Federal taxes. Other top paying states were Florida ($1.49), New Jersey ($1.42), Connecticut ($1.35), and Colorado ($1.28).

At the low end, residents of the Nation's Capital paid 35 cents for a dollar of Federal aid. Favorable balances also prevailed in South Dakota (48 cents), Montana (53 cents), Vermont (54 cents), and Alaska (54 cents).

Tax Foundation's Formula

Tax Foundation's method for deriving the Federal tax burdens borne by residents of each state is designed to show where tax dollars actually originate, rather than where they are collected. The data on grants-in-aid are shown as reported by the Bureau of the Census.

Tax Foundation analysts point out that these comparisons of Federal tax burdens for aid assistance do not reflect the entire costs incurred by state and local governments for obtaining grants. The comparisons, with few exceptions, do not take into account the costs to these governments of administering the programs for which the aid is granted, nor the amounts of matching funds which the state and local governments must make available out of their own revenues in order to qualify as recipients of these grants.

State-Local Costs

For fiscal year 1985, the Administration estimates that state and local governments provided about 50 cents of matching funds for each $1.00 of Federal aid. This matching share is up from 37 cents per $1.00 in 1980, because of significant growth in programs such as medicaid that require a larger than average matching share. Based on these matching shares, as reported in the Budget for fiscal year 1987, Tax Foundation analysts calculate that state-local matching costs of Federal grant programs rose by $17 billion (51 percent) from 1980 to 1985, while Federal grant disbursements rose by $11 billion (12 percent).

The accompanying table provides state-by-state data on Federal grants as compared to Federal tax costs.

Further details are provided in the ***"Memorandum on the Allocation of the Federal Tax Burden and Federal Grants-in-Aid by State, Fiscal Year 1985,"*** available from Tax Foundation for $4.00 (plus $1.00 postage and handling per order).

Federal Grants-in-Aid to State and Local Governments and Estimated Federal Tax Burden for Federal Grants

Fiscal Year 1985

State	Grants[a] (millions)	Percent of total tax burden	Estimated tax burden for grants[b] (millions)	Tax burden per dollar of aid	
				Amount	Rank
TOTAL U.S.	$99,622.5	100.00	$99,622.5	$1.00	—
Alabama	1,674.4	1.27	1,263.3	.75	34
Alaska	609.6	.33	330.6	.54	47
Arizona	1,106.4	1.17	1,161.4	1.05	13
Arkansas	1,005.5	.71	703.7	.70	40
California	10,492.4	12.15	12,102.8	1.15	8
Colorado	1,113.6	1.43	1,429.3	1.28	5
Connecticut	1,377.4	1.87	1,865.1	1.35	4
Delaware	318.0	.28	280.0	.88	29
Florida	3,117.8	4.68	4,659.0	1.49	2
Georgia	2,366.8	2.17	2,161.9	.91	26
Hawaii	435.6	.42	417.6	.96	23
Idaho	425.0	.31	305.9	.72	38
Illinois	4,687.5	5.42	5,403.2	1.15	9
Indiana	1,825.1	2.10	2,094.6	1.15	10
Iowa	1,163.5	1.14	1,134.5	.98	21
Kansas	854.5	1.05	1,050.3	1.23	6
Kentucky	1,749.8	1.20	1,193.9	.68	41
Louisiana	1,779.4	1.62	1,618.1	.91	27
Maine	659.3	.39	386.4	.59	46
Maryland	2,058.4	2.14	2,133.6	1.04	15
Massachusetts	2,842.0	2.88	2,872.0	1.01	19
Michigan	3,958.7	3.70	3,681.2	.93	24
Minnesota	1,980.2	1.76	1,753.6	.89	28
Mississippi	1,167.1	.70	694.8	.60	45
Missouri	1,932.4	1.99	1,983.5	1.03	18
Montana	545.5	.29	287.2	.53	49
Nebraska	674.6	.62	622.5	.92	25
Nevada	371.4	.42	422.5	1.14	11
New Hampshire	418.2	.44	441.2	1.05	12
New Jersey	2,945.2	4.20	4,185.1	1.42	3
New Mexico	728.5	.48	478.7	.66	42
New York	11,092.3	8.35	8,320.8	.75	35
North Carolina	2,131.0	2.15	2,138.1	1.00	20
North Dakota	434.1	.27	265.3	.61	44
Ohio	4,157.9	4.32	4,305.3	1.04	16
Oklahoma	1,229.9	1.28	1,278.1	1.04	14
Oregon	1,240.1	.99	989.6	.80	32
Pennsylvania	4,961.4	4.83	4,816.4	.97	22
Rhode Island	573.2	.41	406.8	.71	39
South Carolina	1,320.8	1.04	1,038.0	.79	33
South Dakota	476.2	.23	230.4	.48	50
Tennessee	1,931.4	1.64	1,629.7	.84	31
Texas	4,469.8	7.13	7,099.8	1.59	1
Utah	714.7	.52	515.3	.72	37
Vermont	336.1	.18	180.6	.54	48
Virginia	2,049.7	2.44	2,430.1	1.19	7
Washington	1,798.5	1.87	1,858.3	1.03	17
West Virginia	902.9	.59	587.5	.65	43
Wisconsin	2,109.9	1.85	1,847.1	.88	30
Wyoming	293.7	.22	215.9	.74	36
District of Columbia	1,018.0	.35	352.0	.35	51

[a]Excludes shared revenues and payments in lieu of taxes; includes General Revenue Sharing and trust fund aids.
[b]The total tax burden for grants is assumed to equal grant payments.
Source: U.S. Department of Commerce, Bureau of the Census; and Tax Foundation computations.

Tax Features

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FEDERAL TAX POLICY MEMO

Editor: Edward A. Sprague, Senior Vice President—Program Planning and Tax Policy

MAY 1986

Minimum Tax—Maximum Tangle

The Senate is being driven more and more forcefully into the minimum tax box, which is finishing off any hope of real tax simplification in the current reform round. The alternative minimum tax is justified most commonly to make all corporations and upper-income individuals "pay their fair share" of tax liability. This carries political weight, to be sure. But now it has been joined by an overarching need for more revenue to balance up the reform package. Because the Finance Committee has been busy stripping away money-raising provisions from Chairman Packwood's draft proposal—and because a lot of the excisions here are likely to stick throughout the Senate consideration—the reformers are desperate for more money from other sources. ***Even if the tax reform program goes down the tube, the alternative minimum tax undoubtedly will remain as a likely revenue plug to dress up the budget deficit.***

Chairman Packwood's alternative minimum tax proposal was originally estimated to raise $46 billion over five years—$25 billion from individuals and $21 billion from corporations. This would be much stiffer than the House tax reform provision in H.R. 3838, particularly in the corporate area. Part of the stiffening was the proposed inclusion of all tax-exempt interest in the minimum tax base. That idea lasted about 24 hours before the collapse in the municipal bond market threw it out of contention. There is still a good chance that some tax-exempt income from "nonessential function bonds"—those subject to volume limitations—may be included, as in H.R. 3838. Another feature of the draft Senate legislation would be to include one-half of book income over the minimum tax base to that point as a preference item. This represents a new direction for the minimum tax concept attempting to reach a broader measure of "economic income," either in *addition to*, or perhaps as a *substitute for*, the rather mixed bag of specific items making up the present minimum tax base. As the search for more revenue intensifies, this direction is likely to be explored further.

Either way, the minimum tax can complicate tax life immensely for millions of individuals and corporations. Under either House or draft Senate version, it would reach well beyond upper-income individuals and corporate tax avoiders. It would hit middle-income individuals with relatively minor participation in tax shelters, emerging corporations without established profit histories, and corporations in cyclical industries who paid little or no tax in dry years but had substantial such liability over a longer period. Furthermore, virtually all corporations and millions of individual taxpayers would have to *contend* with the tax; would have to calculate potential liability even if none actually was incurred. A recent Arthur Andersen report indicated that 8 or 9 major new calculations would be necessary to comply with the House or Senate version of the individual alternative minimum tax.

While we know it would be much more complicated, we don't know really what specific economic impact these minimum taxes would have. The revenue estimates must be viewed with great suspicion. On the corporate side, the impact could be quite erratic depending on the stability of the firm's profits, its adaptability to merger or acquisition, its use of the preference provisions, and, under the Senate version, financial accounting practices heretofore having no direct bearing on tax liability. The effect on the marginal tax rate of firms subject to the alternative minimum tax could be considerably greater than a direct reduction in the preference provisions. And, in the case of incentive deductions, as opposed to credits, the increase in the firm's marginal tax rate occasioned by the minimum tax could be larger than the minimum tax rate itself. While it is difficult to generalize about industry impacts, clearly such a minimum tax would bear harder on firms with low profit margins, even if they were fast growing and not necessarily heavy users of preference items. Also, under the House version, the minimum tax rate of 25 percent on an expanded preference base would be only 11 percentage points below the proposed regular rate of 36 percent. The compression of the two rate structures would tend to push numerous firms into minimum tax liability with no certainty as to a comparable increase in their "economic" income, however defined, to bear higher taxes.

Historical Note

The minimum tax has been with us since the Tax Reform Act of 1969. The genesis was the same "fairness" issue that continues to attract attention today. After the last Secretary of the Treasury in the Johnson Administration, Joe Barr, made his famous reference to the 154 individuals making over $200,000 in adjusted gross income who paid no income tax, the hunt was on. A minimum tax was concocted as the easiest way to get at the tax avoiders without the political pain of having to revise all the special provisions of the Code directly. Revenue wasn't much of a factor, and, initially, there was no intention to apply the minimum tax to the corporate sector. During the Senate consideration of the 1969 bill, however, the focus was changed from an alternative to an add-on minimum tax, and corporations were targeted, too.

Under the 1976 Tax Reform Act, the minimum tax was tightened substantially: the rate was raised to 15 percent, additional items of preference income were added to the base, and, for individuals, the minimum tax deduction for regular taxes paid was cut in half. By 1978, this add-on tax was beginning to bite both individuals and corporations. Although total minimum tax collections were still under $2 billion, there were a lot of objections to the add-on feature, particularly as it could subject individuals with occasional large capital gains to a minimum tax penalty even while making fairly hefty regular tax payments. Having preference income also could "poison" an individual's ability to take advantage of the then maximum tax

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rate of 50 percent on earned income. There was a much greater than intended restriction of the use of the maximum tax process because of this factor. Therefore, under the 1978 Act, the individual preference items for capital gains and "excess" itemized deductions—which were the big target items in the minimum tax base—were pulled out of the add-on tax and subjected to a separate but true alternative minimum tax with graduated rates. Finally, under the 1982 bill (TEFRA), the individual add-on tax was repealed entirely and all preferences, including a few new ones, were thrown into the alternative minimum tax base subject to a flat 20 percent rate.

On the corporate side, the add-on tax has remained in roughly the same structural form, although there has been a general tightening trend coordinated with the scaleback of preference items directly under the 1982 and 1984 tax bills. In overall revenues, the corporate minimum tax has not been a very significant factor, but it has had a severe impact on some industries, such as mining, and produced large headaches for tax planners, especially those in cyclical industries after 1976 when the carryover of regular taxes as a deduction from the minimum tax was repealed.[1]

New Issues

As we contemplate a broader minimum tax, a little bit of the controversy accompanying its checkered career in the 1970s and early 1980s appears to have been resolved. But much of it remains and new issues crop up. There does seem to be agreement that further development of the minimum tax should be on a true alternative basis—that is, the individual or corporate taxpayer would pay it only if its regular tax liability is lower. This accords with the basic mission of the minimum tax—to ensure some tax payment by all with significant economic income—and, most would agree, is intrinsically more equitable than the add-on type of tax. But there is still a large problem of integrating the two structures.

In fact, an alternative corporate minimum tax probably would be more volatile than the present add-on system. There would need to be more careful consideration of carryovers of net operating losses and credits to ensure that taxpayers are not hit capriciously with penalties because of uneven economic performance or past investment decisions. H.R. 3838, for example, does permit incentive credits, such as the investment credit and R & D credit, to offset minimum tax liability, but only in cases where the taxpayer had net operating losses in two of the last three years. This could curtail the benefit of the credits for investments entered into before the alternative minimum tax became a factor and even when the taxpayer had no preference income at all. Retroactive application of the alternative minimum tax to individuals could result from the inclusion of so-called "passive" investment losses in the preference base. It is very difficult to distinguish, for minimum tax or other purposes, between tax motivated losses and those occasioned by profit motivated investments that happened to yield economic losses. But the Senate is plunging on, even considering adding some direct business losses to passive losses as preferences.

[1]For a more thorough history of minimum taxes, see "Background Analysis of Corporate Minimum Tax Issues," staff working paper, Congressional Budget Office, July 1985.

By far the most significant issue is the potential expansion of the minimum tax base to sweep in more broadly defined economic income. The House measure does this to some extent, particularly with respect to the proposed inclusion of tax-exempt income from "non-essential function" bonds and passive investment losses in the base. The draft Senate version takes a larger jump by including half of book income over the minimum tax base to that point in the corporate minimum tax. Other proposals would use corporate earnings and profits as a proxy for economic income or even net business receipts.

It can be argued, of course, that a very broad-based minimum tax at a low rate would be more equitable and involve less distortions than a high-rate tax centered on selective preference items such as under H.R. 3838. According to the Congressional Budget Office, we could raise $35 billion over five years from a 2-½ percent add-on corporate minimum tax on economic income defined as gross business receipts less allowable expenses (wages and salaries, cost of materials, payments to qualified pension plans, and straight-line depreciation of assets) then reduced further by regular tax liability and a $100,000 exclusion. Presumably, we could quite easily raise billions more by jiggling the rate a percentage point or two. It might be quite a good revenue source but would almost completely disregard the current concept of when and where it is appropriate to impose a rate of tax. It might be easier to go whole hog and set up a separate value-added tax.

Using book income as part of the minimum tax base involves a host of complications not the least of which would be giving the accountants and generally accepted accounting standards partial responsibility for defining taxable income. What you do about nonpublic companies, varying rules and degrees of consolidation for book income, foreign subsidiaries and all kinds of other necessary adjustments could produce extreme pressure on financial accounting.

***

Unfortunately, no excursion into constructing a "strong" minimum tax is without major complication of the system. All minimum taxes diminish the value of the special tax provisions included in their base to some extent—provisions that Congress agreed to for presumably worthwhile social and economic objectives. ***Even if one accepts the argument that some devaluation of tax preferences is necessary in order to ensure fuller participation in paying income tax liability, major considerations of basic equity and economic impact dictate a lot of coordination with the regular income tax—necessary adjustments for credits and net operating loss carryovers or basis adjustment in the case of deferral preferences such as accelerated depreciation. Otherwise a "strong" alternative minimum tax can result in taxation where there may be no real economic income or a minimum tax penalty greater than the value of the preference itself—a form of double taxation.***

One must ask also whether the objective of ensuring tax liability for *all* with economic income can be achieved practically through the minimum tax mechanism. We have witnessed the extreme difficulty subjecting tax-exempt bond interest to any new tax. It would be perfectly possible under either the House or draft Senate bills for upper-income individuals to rely on tax-exempt interest for a major source of

income and continue to pay little or no tax regardless of an otherwise powerful minimum tax.

In past reports we have examined some of the ways tax policy can address directly the issue of tax avoidance through shelter investments—and how the market itself disciplines such investment—without resorting to the blunderbuss weapon of the minimum tax. We also observed that the existing income tax structure, flawed as it may be, is still progressive on the individual side and does reach an awful lot of high-income folks for significant tax bites. Statistically, the numbers in the upper-income group that escape entirely or pay less than a 5 percent effective rate are a very small minority. As for the corporate side, there are those firms which, for one reason or another, pay little or no income tax, and rates of effective tax on corporate income have declined. But particularly when one factors in the effect of state/local and payroll taxes, corporate tax burdens are still very substantial.

If fairness cannot be fully served by resort to the minimum tax or only served with economic dislocation and extreme complication, what would justify setting up a whole new system of income taxation to parallel the somewhat creaky present one? If it is merely the additional revenue projected, is there a better way to deal with that? Congress does seem determined to enact a bigger minimum tax, but it ought to keep asking, at what price?

*****

Tax Reform—Probing the Process

In the current mode of tax reform, Congress is being asked to make many sweeping changes in the structure all at once, in a single, if not very neatly arranged, package. There are obvious reasons for going this route. Because rate reductions and an increase in the personal exemption have been made central priorities, keeping the package revenue neutral, at least on paper, almost requires looking at everything for base-broadening potential. Most players in the process say they need the revenue-neutral discipline to move the program and prevent it from degenerating into a slew of revenue-losing exemptions.

Past efforts at tax reform in 1969 and 1976 did not attempt to comb through the entire Code and ended up as net tax reductions. Of course, we didn't have such a budget deficit fixation then. It wasn't deemed that important to balance the program.

Now Congress finds itself about two-thirds of the way through the reform process, still trying to keep everything under one tent, but, obviously, running out of base-broadening or other options to preserve that revenue neutrality. Some of this is inevitable as the more elegantly structured plans of tax reformers are ground through the legislative mill. The proposals that set off the loudest howls—such as disallowing state/local tax deductions—are dropped or modified, and there is a scramble to find new revenue sources—such as excise taxes—which in turn sets off new howls.

There is a tendency in the popular press to blame the "special interest" lobbyists for sullying the concept of tax reform in this matter. A recent* Time *cover story bemoaned the influence of swarms of lobbyists descending on Washington, lining up in "Gucci Gulch," outside the Ways and Means Committee offices. Which must strike many individual lobbyists as cruelly ironic. If they had so much power, why were they standing out in the hall? And why would they have to contend with such legislation at all? The fact that tax reform is still alive in the U.S. Senate (at this writing) and still contains many provisions to impose new tax burdens on various economic sectors—mostly on business sectors—would hardly indicate that the business interests are calling all the shots.

But the fact of the matter is that Congressmen, including members of the Ways and Means and Senate Finance Committees, are simply not equipped to deal with the mass of proposed changes affecting so many aspects of economic life, especially at one time. Many of the proposals involve extremely complicated areas of the Code. (Who really understands and can explain taxation of the insurance industry?) Often to scrounge more revenue they would make it even more complicated. ***No matter how good the staffs, it is simply impossible for individual Congressmen and Senators to master all the economic and social implications. Therefore, they really need the reaction of the "lobbyists," or whoever is representing the affected taxpayers, to gauge the importance of various proposals—not to mention the chances of being blindsided at the next election.*** Otherwise, they are almost entirely dependent on what they have gleaned from the hearing process and, of course, Treasury and congressional staffs.

In fact, in a bill so cumbersome as H.R. 3838, there are a number of areas where Congress has not heard *enough* from the affected parties and where it has relied perhaps too much on staff assertions and staff revenue estimates. Ready examples may be found in the retirement income provisions.

Pension Problems

The tax treatment of retirement income had been visited repeatedly by major legislation in 1974, 1978, 1982, and 1984. The urgency of further reforms would seem questionable. But both the President's program and the House bill put forth a whole slew of them. Despite Chairman Packwood's earlier statement that the employee benefits area should be left alone, the draft Senate Finance program devoted a full 20 percent of its pages to retirement income and employee benefits changes. Much of the press coverage and congressional attention here have been on 401(k) plans, which have many defenders and seem sure to survive, albeit, perhaps in less useful form. Some other areas have received much less attention or less *effective* attention.

Both the House reform bill and the draft Senate bill would tighten the limitations on contributions and benefits under qualified plans, including a more comprehensive combined limit on distributions from all tax-deferred plans and a 15

percent excise tax on aggregate "excess" distributions. The House measure, in particular, is more restrictive of defined contribution plans. The present $30,000 limit on annual additions would be reduced to the greater of $25,000 or 25 percent of the defined benefit plan limitation—which in turn would be lowered from $90,000 to $77,000 under the bill. The cost-of-living adjustment to the $25,000 limit on defined contribution plans would be suspended until the limit reaches 25 percent of the defined benefit limit. If inflation is a "modest" 4 percent annually, that would take seven years with the defined contribution limit effectively frozen at $25,000. There is no separate revenue estimate for this distinction, but the combination of Section 415 limitations is expected to raise about $1.7 billion over five years.

A $25,000 top on defined contributions is not likely to affect a great mass of participants, at least not in the immediate future, and has not produced much of a hue and cry. The House bill's rationale, however, seems quite arbitrary. According to the House Ways and Means Committee Report, the Committee deliberately wanted to favor defined benefit plans, alleging that they provide "better overall retirement security" because the participants are protected against bad investment experience, and, with most benefits based on final average pay, better protected against inflation.

It's probably true that defined benefit plans are more suited for long-service workers in stable employment situations with the expectation of fairly steadily rising income. But they are not that well suited where employee turnover is high, such as in the service trades, and many other areas of the economy where the greatest growth in employment has occurred. Employees who change jobs with some frequency, but still vest their pension rights, are likely to do considerably better under defined contribution plans, where they at least have the continuing benefit of accrued interest earnings, than under defined benefit plans with the same vesting schedule but which can make no allowance for earlier periods of coverage. It is obviously easier to introduce more portability—or effective vesting protection—into defined contribution plans. Interest earnings under such plans also will reflect inflation trends as interest rates tend to rise and fall in rough correlation with the inflation rate. (Typically, neither type of plan offers any guarantee against inflation, nor is it necessarily advisable to attempt to do so.) Lastly, while it is true that participants in defined benefit plans are shielded from bad investment experience to the extent that the employer is responsible for set results and the Pension Benefit Guarantee Corporation is there to back up shaky plans, it's also true that the plan participants may not benefit at all from *above average* investment experience. In the case of defined contribution plans, both above average and below average investment performance will flow directly to the account of the participant.

The real point is not that one type of plan is better than the other, but that they serve different needs and that the parties thereto should be in the best position to judge their applicability. Certainly, it can be argued that tax-deferred plans should be subject to some limitation on amounts contributed or distributed. But to favor one plan over another for policy purposes would seem to demand further explanation and exploration of the issues than given in the House Report.

In respect to limitation of *employer* contributions, both the House and draft Senate bills extend the 25 percent of total compensation limit under Section 404 to *any* combination of a deferred benefit plan and defined contribution plan. This is proposed in the name of uniform treatment. The problem is that the economic context of recent years has forced many employers to reduce their work forces significantly and, thereby, incur significant increases in unfunded liabilities under their primary defined benefit plans. With the need for additional contributions to fund these defined benefit plans, employer contributions to money purchase pension plans could be squeezed out by the more stringent limits. Again, it is not necessarily the concept of some limitation that is at issue, but its potential harsh application.

Incremental Approach Next Time

These two examples only scratch the underside of the questions raised about proposed pension and retirement income changes. There are a lot more, and some more prominent, with respect to tax-deferred savings, lump sum distributions, asset reversion to employers, etc. A number of them were covered in our Working Paper, *Tax Treatment of Retirement Savings—Success Under Attack*, of December 1985.

Our examples do serve to underscore two broader problems of tax reform. One, and most obvious, the objective of absolute uniform treatment is very difficult to apply in a diverse economy because market sectors are not uniform and rigid rules for all cases inevitably will choke off market response. Two, less remarked but quite important, ***Congress simply doesn't have the time or leeway under the present modus operandi to examine with appropriate thoroughness all the issues involved. Provisions attracting the most heat will be modified, but others, perhaps more, or no less, deserving of modification in terms of sound policy choices, will not be examined because of the need to maintain revenue plugs and/or because the Committee must press on with its schedule.***

What this would argue for in the inevitable next round of reform, whether that is to pick up what is not accomplished, or to repair what is accomplished, in this round, would be a more deliberate, incremental approach. The danger of dangling large individual tax reductions as the target for the reform movement is now more apparent. As worthy as the objective of rate reduction is, the manner in which the carrot has been offered has set off an across-the-board scramble for makeup revenue that does not do justice to policy choices.

Tax Index Hits 529.4: Nation's 1985 Tax Bill Is Nearly $1.2 Trillion

The Tax Index climbed to a new high of 529.4 in 1985 (1967 = 100), as the nation's total tax bill hit $1.172 trillion, more than five times the level recorded for the base year 1967.

The total—which includes Federal, state, and local taxes—reflects a rise of $84.3 billion, or 7.7 percent in calendar year 1985 over the previous year.

The increase in taxes was 2.0 percentage points (35 percent) higher than the concurrent 5.7 percent gain in the Gross National Product (GNP), the gross market value of goods and services. (Inflation-adjusted GNP rose 2.2 percent, and general prices, 3.3 percent during the year.)

The Tax Index is a fiscal yardstick designed by Tax Foundation economists to provide a continuing measure of trends in taxes, on a basis comparable to official indexes for other segments of the economy.

Since 1982, the year in which the last recession bottomed out, the annual Tax Index has risen from 421.6 to 529.4 (1967 = 100), or 25.6 percent. Although the Economic Recovery Tax Act of 1981 (ERTA) slowed their rise, Federal taxes have gone up over 23 percent since 1982. State-local taxes have risen faster, by just over 30 percent. The growth pattern in the overall Tax Index has been virtually the same as the 26 percent gain in GNP over the same period.

Among the separate components of the Tax Index, the corporate profits index has scored the largest percentage gain since 1982. It has climbed by 35 percent. (The corporate index is also the most volatile index component because of the sensitivity of corporate profits to the business cycle.) Its rate of growth was followed by an increase of 32 percent in the social insurance taxes index; 26 percent in indirect business taxes (property, sales, selective excises); 20 percent in the personal income tax index; and 3 percent in the index for all other taxes.

Measured against the 1967 base year, contributions for social insurance have outpaced all other types of taxes, reaching a 1985 index of 785.6. The Federal index of 805.8, which covers the lion's share of social insurance levies, is running well ahead of the state-local index of 671.6.

The next highest growth since 1967 has occurred in personal income taxes,

(Continued on page 4)

THE FRONT BURNER

By Robert C. Brown, President
Tax Foundation, Incorporated

"CPI Minus 2 Revisited"

Some ideas, like vintage wine, have to mature. CPI Minus 2 may be just such an idea.

Originally introduced in 1983 by Rep. James R. Jones of Oklahoma, then Chairman of the House Budget Committee, CPI Minus 2 was a shorthand label for a new approach to fiscal policy. In essence, Jones sought to put a lid on the growth of inflation-adjusted entitlement benefits and a floor under the rates of inflation-adjusted tax tables. He saw a major flaw in fully indexing entitlements to the consumer price index (CPI), which was compounded when indexing was applied to the tax bracket tables under the 1981 tax bill.

Indexing allows old age, survivors, and disability insurance; armed services retirement; civil service retirement; Federal worker compensation for job-related injuries; and railroad retirement—so-called entitlements—to grow automatically with inflation. Tax indexing shields taxpayers from the ratcheting effect of inflation on the tax rate brackets and personal exemptions.

The net effect is a two-way squeeze on the Federal budget—indexing automatically increases benefit levels and simultaneously holds down revenue growth. Indexing can overcorrect, compounding the shortfall between outlays and revenues.

CPI Minus 2 would reduce the spending and tax adjustments by two percentage points. This would trim the budget deficit but still allow good protection against really high inflation, should that recur.

CPI Minus 2 would also have a number of other beneficial effects:

1) The sacrifice would be shared about equally by those who receive income from the Federal programs and those whose income is taxed to fund the programs.

2) The impact on deficit reduction would be permanent and cumulative, even if inflation stays moderate. A dollar saved in 1986 becomes a lot more saved in 1990—especially when you count the interest that would have to be paid on that dollar if it were part of the national debt for four years.

3) The savings are structural—built into both the spending programs and the tax rates. They work toward deficit reduction just as automatically as indexing now works against it.

Given the stubbornness of the deficits and the inability of Congress to meet the first Gramm-Rudman-Hollings target on April 15, perhaps CPI Minus 2 has aged long enough. Let's tap the cask, and see whether, like fine burgundy, its time has indeed come.

(*COST OF CONGRESS, from page 1*)
in 1986—$297 million for the Senate and $472 million for the House of Representatives. Per Senator, that translates into about $3 million; $1.1 million, per U.S. Representative.

Joint activities of both Houses of Congress will run up costs of $152 million this year—a whopping 57 percent above 1985 outlays, according to researchers at the Washington-based tax watchdog organization. Most of the increase, they say, is due to a proposed rise of $55 million in official mail costs, part of which is still pending in Congress. Congress wants to spend $141 million for its 1986 official mail costs. Joint activities of both Houses will add nearly another $285,000 per Member of Congress.

Various other legislative agencies will spend an additional $1.2 billion, a rise of 30 percent, or $239 million, over 1985.

The table on page 1 provides details.

"Working Papers and Other Reports"

"Working Paper" Series: $3.00 each. Members $5.00 each. Nonmembers—includes postage and handling. Order from Publications Department, Tax Foundation, (202) 822-9050.

"Tax Reform—Probing the Process," April 1986, 8 p.

"Business Tax Burdens—II," January 1986, 6 p.

"The House Tax Bill," January 1986, 15 p.

"Gramm-Rudman-Hollings: A Bad Idea Whose Time Has Come," December 1985, 8 p.

(Summaries of some of these papers may appear as articles in *Tax Features* or in *Federal Tax Policy Memo*.)

"Achievability of Fiscal 1987 Budget Targets," A Report by The Shadow Committee on the Federal Budget, Tax Foundation, March 1986, 16 p. Single copies free.

(*TAX INDEX, from page 3*)
the largest single revenue producer among all tax sources. Reflecting collections of $417.3 billion, the personal income tax index stood at 591.9 in 1985. State-local personal income taxes are now more than 12 times their 1967 base, at an index of 1202.6. The Federal index for personal income taxes has more than quintupled, rising to 533.7. These trends reflect a long-time tendency for state-local personal income taxes to grow relative to those in the Federal sector; in 1967 personal income taxes of subnational levels of government were less than 10 percent of the amounts collected by the Federal government. By 1985, state-local personal income taxes were more than 20 percent of the Federal personal income tax take.

The table below provides additional details for the Tax Index and its Federal and state-local components.

Tax Index by Level of Government and Type of Tax, Selected Periods 1980-1985[a]

Index Numbers, 1967 = 100

Type of tax	1980	1981	1982	1983	1984	1985
All governments						
All taxes	364.0	414.9	421.6	445.0	491.4	529.4
Personal income	416.6	481.7	494.2	492.1	528.5	591.9
Corporate profits	260.1	248.8	193.3	230.7	287.1	261.0
Indirect business[b]	295.4	347.4	355.1	386.7	423.0	448.7
Social insurance contributions	479.3	556.8	596.6	643.9	719.4	785.2
All other[c]	237.5	251.6	273.4	254.7	262.5	282.8
Federal government						
All taxes	362.4	418.5	414.6	429.5	472.8	511.6
Personal income	389.9	453.0	460.4	448.1	473.4	533.7
Corporate profits	234.3	219.0	163.3	197.7	248.0	223.7
Indirect business[b]	223.7	330.9	271.7	295.4	316.4	314.5
Social insurance contributions	485.7	569.5	607.7	656.0	736.9	805.8
All other[c]	212.9	225.8	245.2	190.3	190.3	209.7
State and local governments						
All taxes	367.3	407.2	436.6	477.9	530.7	568.0
Personal income	698.4	785.2	850.8	955.7	1,109.8	1,206.6
Corporate profits	557.7	592.3	538.5	611.5	738.5	692.3
Indirect business[b]	316.3	352.2	379.3	413.2	453.9	487.8
Social insurance contributions	443.3	485.1	534.3	576.1	620.9	671.6
All other[c]	260.6	275.8	300.0	315.2	330.3	351.5

[a]Most taxes are shown on an accrual basis.
[b]Includes sales, excise, and customs levies, and real property taxes (including those on owner-occupied homes).
[c]Estate and gift and personal property taxes.
Source: Tax Foundation computations based on data from the U.S. Department of Commerce, Bureau of Economic Analysis.

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TAX·FEATURES

Top 10% of U.S. Earners Pay Half The Federal Income Tax Bill

The top-earning half of the population pays more than 90 percent of the Federal income tax bill, Tax Foundation analysis of data for tax year 1984, recently released by the Treasury Department, reveals. Earners in the top tenth pay over half of the bill.

These proportions were almost the same in 1984 as in 1979, and distribution of Federal income tax burdens among higher and lower income earners has been remarkably stable in recent years, despite major statutory changes affecting taxes at all income levels. There has been a tendency, however, for those at the upper end of the income scale to pay an increasing share of the individual income tax.

The top 5 percent of income earners in 1984 shouldered 38.2 percent of the tax bill in 1984, up from 37.6 percent in 1979. This upward shift of the tax burden occurred despite the reduction in the top marginal rate on all income from 70 percent to 50 percent in the interim.

Federal individual income taxes totaled $304 billion in 1984. Over $282 billion—92.9 percent—was paid by the top 50 percent of earners—represented by the 50 million returns with incomes of $15,837 or more. This group paid an average tax of $5,669. Five years earlier, the upper half paid 93.2 percent.

The 10 million taxpayers in the top ten percent grouping shouldered 51.0 percent of all U.S. personal income taxes in 1984—a shade more than their 49.5 percent share in 1979. In 1984, this group had adjusted gross incomes of $44,656 or more, with an average tax burden of $15,549.

The highest five percent of earners in 1984 had adjusted gross incomes averaging $59,460 or more and paid an average tax of $23,313, according to economists at the Tax Foundation.

Taxpayers in the lower half of the earning scale—those making $15,836 or less—paid only 7.1 percent of Federal income taxes in 1984, with an average tax of $434. Their share of the tax bill was up slightly from 6.8 percent in 1979.

For all filers, the average tax per return in 1984 was $3,052, an in-

(Continued on page 3)

Federal Income Taxes Paid by High- and Low-Income Taxpayers
1979 and 1984[a]

Adjusted gross income class	Income level 1979	Income level 1984	Percent of tax paid 1979	Percent of tax paid 1984	Average tax 1979	Average tax 1984
Highest 5 percent	$39,901 or more	$59,460 or more	37.6	38.2	$17,407	$23,313
Highest 10 percent	32,711 or more	44,656 or more	49.5	51.0	11,456	15,549
Highest 25 percent	21,759 or more	29,316 or more	73.1	74.0	6,769	9,035
Highest 50 percent	11,870 or more	15,837 or more	93.2	92.9	4,315	5,669
Lowest 50 percent	11,869 or less	15,836 or less	6.8	7.1	313	434
Lowest 25 percent	5,565 or less	7,337 or less	.5	.8	46	92
Lowest 10 percent	2,212 or less	2,939 or less	(b)	.1	9	31

[a]Data for 1984 are preliminary.
[b]Less than .05 percent.
Source: Tax Foundation computations based on Treasury Department data.

Spending Doubles in 7 Years As Governments Shell Out $7,017 Per Person in FY86

Spending by Federal, state, and local governments has more than doubled since 1979, and will hit $1.69 trillion in the current fiscal year, according to Tax Foundation analysts.

Public spending in fiscal 1986 will reach $7,017 per person, up from $3,726 in 1979. Per household, that comes to $19,145 this year for each of the 88 million U.S. households, as compared to $10,764 seven years ago.

But the rate is slowing. Compared to an average annual growth in excess of 11 percent during the first half of the 1980s, spending this year is expected to rise by 6.0 percent, or $95.4 billion over the previous year—a modest increase by recent standards. Tax Foundation economists attribute the slowdown primarily to an estimated increase in Federal outlays of only 3.5 percent, the smallest annual rise in more than a decade. State and local expenditures will grow this year by about 10 percent, as compared to previous annual increases averaging nearly 13 percent since 1980.

The Federal government will spend $1.06 trillion in fiscal 1986, about 63 percent of the total for all governments. Over the past two decades the share of Federal spending in the rising total for governments has remained relatively stable, within a range of 61 to 65 percent. This has not always been the case, however. Tax Foundation researchers point out that Federal spending was less than 50 percent of all public

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The In's and Out's of Public Revenue

How It Comes In

Individual income taxes were the largest single revenue source for U.S. governments in fiscal year 1984 (latest reported), accounting for 27.6 cents of every dollar collected by Federal, state, and local jurisdictions, according to Tax Foundation researchers.

Nearly $361 billion of the $1.3 trillion governments raised in 1984 came from individual income taxes.

Social security payroll taxes were the second largest contributor to government coffers, bringing in $214 billion, or 16.3 cents per revenue dollar. Next came current charges, 10.2 cents; miscellaneous general revenue (e.g., interest earnings and sales of property), 8.2 cents; property taxes, 7.4 cents; selective sales and excise taxes, 6.8 cents; general sales taxes, 5.8 cents; corporate profits taxes, 5.7 cents; and miscellaneous taxes, 4.6 cents.

Despite the continued preeminence of individual income taxes in financing government—they have held the top spot since World War II—their share of total revenues dropped from 30.7 cents per dollar in 1980 to 27.6 cents in 1984. This trend reflects two major factors, according to Tax Foundation analysts. One is that other revenue sources, notably nontax revenues and social security levies, are rising more rapidly than personal income taxes. The other is the slowing in the rise of Federal income taxes as a result of the Economic Recovery Tax Act of 1981 (ERTA). (More than four-fifths of all personal income taxes are collected by Uncle Sam.)

Tax Foundation economists note several major changes since 1960 in the way governments raise their money.

The role of taxes has declined relative to nontax revenues. (See the accompanying table for breakdown of nontax revenues.) The share of taxes in the revenue dollar dropped from 82.7 cents in 1960 to 74.1 cents in 1984; mostly after 1970. In 1984, nontax revenues were nearly 13 times their size in 1960; taxes were not quite eight times their 1960 levels.

Social security taxes, the fastest growing revenue source, have more than doubled their share in the total revenue system, rising from 7.0 cents per revenue dollar in 1960 to 16.3 cents in 1984. In 1984, social security taxes were 20 times as large as in 1960.

Over the same period, corporate income taxes, selective sales taxes, and property taxes have played a declining role in the overall revenue structure.

Revenue figures do not reflect the large segment of Federal spending that is now financed by borrowed funds. In 1984, nearly 19 cents of every dollar of Federal spending was borrowed. This was partly offset by state-local surpluses, to bring net borrowing by all governments down to 8 cents per dollar of spending. (In 1960, a surplus in Federal accounts more than offset a smaller deficit in state-local accounts.)

Additional details appear below.

How It Goes Out

Social welfare programs consumed 32.9 cents of every government dollar spent in 1984 (latest reported). Nearly one-third of all 1984 public expenditures, some $470 billion out of total spending by all levels of government of $1,428 billion, went to support the social welfare network.

National defense and international relations was the second highest at 17.4 cents per dollar. Education expenditures ranked third, taking 13.2 cents per dollar; interest costs ranked fourth at 9.7 cents; and environment and housing followed at 5.8 cents.

Federal social security (OASDHI) led the field, claiming 16.4 cents of every dollar spent by all levels of government. Programs in this category also include social services and income maintenance (public welfare, health and hospitals, and unemployment insurance), which accounted for 11.8 cents per dollar of government spending. Other programs included are government employee retirement, railroad retirement, and veterans' programs not elsewhere classified—4.7 cents.

Even these large percentages for social welfare spending actually understate what could be considered the "true" social spending total, according to economists at the Tax Foundation. Broadly defined, social welfare might include public education (shown separately in the table on page 4), as well as subsidized housing and many veterans' services that are included in and not segregable from the totals of other spending categories.

(Continued on page 4)

How Federal, State, and Local Governments Raise Each Dollar of Public Funds
Selected Fiscal Years 1960-1984

Source	Cents per dollar of total revenue			
	1960	1970	1980	1984
Tax Revenues	82.7	82.4	78.2	74.1
Individual income	28.2	30.3	30.7	27.6
Social Security (OASDHI)	7.0	11.5	15.0	16.3
Property	10.7	10.2	7.3	7.4
Selective sales and excises	12.5	9.8	6.5	6.8
Corporate income	14.8	11.0	8.4	5.7
General sales	3.5	4.8	5.5	5.8
Other taxes[a]	6.0	4.8	4.8	4.6
Nontax revenues	17.3	17.6	21.8	25.9
Current charges	8.1	7.9	8.6	10.2
Miscellaneous general revenue[b]	3.3	4.0	6.7	8.2
Employee retirement	1.9	2.5	3.1	3.9
Utilities and liquor stores	3.2	2.6	2.7	3.1
Other nontaxes	.8	.6	.7	.5
Exhibit (billions):				
Total revenues	$153.1	$333.8	$932.2	$1,307.5
Surplus (+) or deficit (−)	+$ 1.8	+$ .8	−$ 26.5	−$ 120.5

[a]Includes death and gift, motor vehicle and operators' license, unemployment compensation, and miscellaneous taxes.
[b]Includes interest earnings, special assessments, sale of property, and others.
Source: *Facts and Figures on Government Finance*, 1986, Tax Foundation; basic data from U.S. Department of Commerce, Bureau of the Census.

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FEDERAL TAX POLICY MEMO

Editor: Edward A. Sprague, Senior Vice President—Program Planning and Tax Policy JUNE/JULY 1986

Tax Reform Accelerates in the Senate

The May resuscitation of tax reform in the Senate Finance Committee has been called Senator Packwood's "Inchon landing." It was indeed a brilliant maneuver, which captured the imagination of both participants and policywatchers. Lots of folks promptly lined up to support the measure, including a good number of former doubters. At this writing, the bill has sailed through the Senate almost wholly intact and awaits the climactic conference with the House.

Key to the success of the "landing" was a proposed dramatic lowering of top marginal rates: from 50 percent to 27 percent for individuals and from 46 percent to 33 percent for corporations. This made the House bill's comparable top rates, at 38 percent and 36 percent, respectively, look positively chintzy. To recapture revenue loss to rate reduction and to balance up the distribution of tax reductions on the individual side, the Finance Committee proposed four major changes: eliminating the long-term capital gains exclusion, disallowing tax shelter losses against other income, eliminating the consumer interest deduction entirely, and limiting IRA deductions to those without regular pension coverage. None of these would have been acceptable, probably, *without* the sharp rate cut. But when wrapped in with reform that editorial writers have been falling all over each other to endorse with high praise, these base-broadening provisions have drawn remarkably little opposition.

However, the promise of real *system* improvement is confined almost entirely to the individual sector. ***On the business side, the Senate bill would saddle corporations with many new tax planning complexities, including a mind-boggling alternative minimum tax. Then, there is the matter of the $100 billion or so in new tax burdens that would be imposed on the corporate sector to finance tax reductions for individuals—less of a shift than under the House bill, but hardly inconsequential.*** What would be the net effect of this burden shift and rate reduction is still anybody's guess. The econometric modelers have no better handle on it than they did a year and a half ago with Treasury I.

On the individual side, there are a lot of potential glitches which need to be ironed out and some real policy questions that should be addressed.

Individual Provisions

At first glance, the Senate's proposed individual rate structure looks like a model of simplicity with only two brackets and a generous standard deduction and personal exemption helping to lop a lot of low-income taxpayers off the rolls entirely. For joint returns, the top rate of 27 percent would kick in at $29,800 of taxable income, compared to House rates of 25 percent on taxable income of $22,500-$43,000; 35 percent on $43,000-$100,000; and 38 percent over $100,000. However, to hold down the lost revenue and size of tax cuts for upper-income groups, the Finance Committee proposed phasing out the benefits of its first 15 percent bracket rate between $75,000 and $145,000 for joint returns and at lower amounts for head-of-household and single returns. It also proposed phasing out the benefit of the entire personal exemption between $145,000 and $185,000 for joint returns and lower amounts for others.

The result would be notch problems for a lot of upper-middle-income taxpayers with the top marginal rate rising temporarily to over 32 percent, instead of the statutory 27 percent. (In isolated cases when the effect of phasing out the $25,000 exemption to the passive loss limitation on real estate shelters is reflected, the marginal rate could rise significantly to over 40 percent.) Generally, this would make very little difference to taxpayers in the $200,000-and-over category, who would have essentially a flat rate of 27 percent on all taxable income. Such notches, however, do pose tax planning difficulties, and rate notches, in particular, are a disadvantage to marginal work and investment effort.

A smoother way of handling it would be to change the personal exemption to a credit at the same rate to all eligible taxpayers. With high marginal rates, the exemption is much more attractive to upper-income groups than a credit with the same overall revenue consequence. With the prospect of two basic rates and a much reduced top rate, the relative advantage/disadvantage of an exemption versus a credit is reduced, too. If the benefit of the 15 percent first bracket were kept for all taxpayers in combination with a low rate personal credit, the notch problems could be avoided. Admittedly, this could not yield exactly the same tax burden distribution as under the Senate bill, but it would be a lot cleaner.

Some other observations:

(1) ***Capital Gains.*** Undoubtedly, the biggest shock in the new package is the proposed ordinary income treatment of long-term capital gains—going directly against the grain of the 1978-81 legislation, which substantially strengthened the capital gains differential. Many tax reformers, of course, long had sought ordinary income treatment for capital gains on the grounds of both equity and simplification. To have it surface in the Finance Committee, however, must have been as much a surprise to those reformers as it was to proponents of a significant capital gains differential.

As to the impact on investment incentives, the jury could be out for a long time, possibly forever. If a top individual tax rate of 27 percent could be implemented and *maintained*, it could be argued that this would more than offset an increase in the effective rate on capital gains. For the Senate initiative, it is a very important *quid pro quo*, not so much in overall dollars, but in balancing the distribution of burdens among income classes and as a trademark for reform.

It is pointed out that the *potential* increase in tax on capital gains for some taxpayers is significantly more than the 7

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percentage point increase from the 20 percent maximum now to 27 percent under the Senate plan. Depending on their place in the rate structure and what their states do about income tax rates, some middle-income taxpayers could experience a capital gains tax hike of 15 or more percentage points.

Moreover, the Senate is proposing no corresponding change in the treatment of capital losses. Basic policy would say that if capital gains are taxable at ordinary income rates, all net capital losses should be allowed against income, too. But no, the Senate has bought the Treasury line that this would encourage too much hanky-panky in the timing of taking capital losses and erode the fisc.

Over the past decade or more, there has been much debate over the need for liberal treatment of capital gains to attract venture capital and risk investment generally. There seems to have been agreement that a capital gains differential has been important to offset high marginal rates of regular tax, at 50 percent or higher, facing the typical investor on such projects. The prospect of much lower top rates could neutralize some of the concern for a capital gains differential in this respect. ***Where productive assets are held over a long period, there would be more potential for erosion of the capital base by full taxation of gains, including the effect of general inflation. This would argue for a reexamination of the possibility of indexing the basis of capital assets, perhaps as proposed in Treasury I.*** If phased in, such indexing need not have such a significant effect on revenues over the next five years.

(2) ***IRA's.*** Almost as surprising as the capital gains proposal and causing even more commotion, was the Finance Committee provision to eliminate IRA deductions for those with regular pension coverage—again reversing one of the principal thrusts of the Economic Recovery Tax Act of 1981 (ERTA).

In a real sense, IRA's became victims of their own success. As of 1985, there were 17 million returns claiming IRA deductions, representing almost 20 percent of all returns eligible and $41 billion in deductions. The revenue cost of IRA's, according to the Treasury Department's "tax expenditure" budget, is said to be about $15 billion in fiscal 1986 and growing very rapidly. So when the Finance Committee was looking for big hits to offset the cost of their rate reductions, IRA's could hardly be missed. The estimated five-year tax savings under the Senate plan—which would still allow IRA deductions for nonparticipants in regular pension plans and, more importantly, continued deferral of tax on IRA earnings for all present eligibles—is estimated at $27 billion.

The IRA vehicle has been criticized as favoring upper-income taxpayers while not contributing to overall net savings. It's true that IRA utilization rises sharply with income. That's quite natural, because savings potential is concentrated in upper-income groups. But utilization has been significant in the middle-income group, too: over 20 percent of eligible tax returns have IRA's in the $20,000-$30,000 AGI group and over 30 percent in the $30,000-$40,000 AGI group.

(3) ***Tax Shelters and Itemized Deductions.*** Much comment has been made about the Finance Committee's bold move against tax shelters, particularly the proposed disallowance of "passive" losses against other income. There's little question that this provision would alter drastically the packaging of real estate and other investments, putting much more emphasis on potential economic returns as opposed to shelter opportunities. ***Also in conjunction with the proposed ordinary income treatment of capital gains, the shelter limitation would take a lot of pressure off the individual alternative minimum tax, reducing its bite and, indeed, sapping the very rationale for a stiff minimum tax, as capital gains and shelter losses have been a primary means to reduce upper-income tax liabilities.*** On these grounds, the Finance Committee move has garnered quite widespread support, including most tax policy observers. Transition problems could be quite intense, however, and there is legitimate question as to whether the proposed five-year phase-in of the disallowance is long enough for equitable treatment of investors in existing shelters.

Actually, in dollar terms, the shelter proposal does not appear to be so radical. Its estimated *net* revenue gain over five years is $19 billion, much lower than the initial estimate in early May. In contrast, the two major proposals to limit itemized deductions—the repeal of consumer interest and state/local sales tax deductions—together are said to raise far more, about $46 billion over five years. ***From a policy viewpoint, consumer or nonbusiness interest always has been a suspect itemized deduction. Heretofore, there has never been enough political support to counter the likely economic dislocation that ending the consumer interest deduction would engender. In the context of the lower rate quid pro quo, opposition to ending the consumer interest deduction has softened even among some large producers of consumer durables who traditionally depend on consumer finance arrangements to move their products.***

Such does not extend, however, to mortgage interest, which under the Senate bill would remain fully deductible for both primary and other residences. No matter how sophisticated the enforcement technique, there is no way the IRS would be able to contain leakage of deductible mortgage interest to finance consumer purchases. And this could produce some significant compliance controversy in the future.

Reaction to the Finance Committee proposal to end deduction of state/local sales taxes was muted, relative, at least, to the furor in the House over the Administration's original suggestion to repeal all state/local tax deductions. This column has never viewed the case for repealing state/local tax deductibility as compelling or particularly well grounded. It must be admitted that on both political and policy grounds, the sales tax deduction is more vulnerable than income or property tax deductions. Clearly, there is a larger element of consumer choice and smaller element of business expense with sales taxes compared to income taxes.

Is it appropriate for the Federal government to influence the states' choice of fiscal resources? Ending or greatly diminishing the sales tax deduction alone would seem to encourage the states to rely more on income/property taxes.* To the extent they do, of course, the potential revenue gain to the U.S. Treasury—plugged in at $17.5 billion over five years—would be diminished. Just one of the innumerable cases of

*The Senate did accept an amendment to the Finance Committee bill that in effect would preserve 60 percent of the sales tax deduction for taxpayers in the few states with sales but no income taxes. This increases the likelihood of a conference move to preserve the entire sales tax deduction.

possible reactions to policy change that cast doubt on the static revenue estimates.

Tax Burden Distribution and Base Broadening

As with the House bill, the basic distribution of tax burdens under the Senate plan is not significantly different from the present level. This has been a guiding principle right along since Treasury I. The Senate version is slightly less generous in overall individual reductions than the House because of the somewhat smaller hit on the business sector to finance them. Some are criticizing the Senate bill for being more niggardly toward the broad middle-income classes of $30,000-$75,000 than the House version, and, inevitably, all sorts of examples have been raised of middle-income people who would pay higher taxes under the Senate bill than under present law, because of their particular circumstances and use of present provisions.

It should be noted that even with sharp cuts in top rates under the Senate bill, progression of the individual structure actually could edge up—that is, upper-income taxpayers could end up paying a higher share of total individual income tax receipts. Such a trend has been in evidence for the past several years, as reported by the Tax Foundation's special analysis of shares paid by high- and low-income taxpayers. (See *Tax Features* story on page 1.) One rationale is that as rates were cut in 1978-81, taxpayer response has been to increase attention to taxable activities—earned income and taxable investments—as opposed to tax shelter or leisure alternatives.* The same could apply to a greater extent under the new legislation.

Table I below shows the average tax liability and rate under present law and under both House and Senate measures. Unfortunately, the figures in the Committee reports are not really comparable. The Senate report uses 1988 income levels based on 1986 dollars, while the House uses 1977 income levels in current dollars. This gives the misleading impression of somewhat lower average taxes and tax rates for income classes under the Senate version. But the essential preservation of the present burden distribution is apparent, anyway.

Gross base broadening of the individual income tax structure is quite extensive under the Senate bill. Table II indicates the estimated revenue pickups by major provision over the five-year period fiscal 1987 through 1991, cumulating to $260 billion for all provisions affecting individuals. This compares with an estimated $193 billion under the House bill for the five fiscal years 1986 through 1990. In each case, of course, rate reductions, personal exemption increases, and other adjustments would more than wipe out these revenue gains resulting in substantial net tax reductions for individuals, more so with the House version than the Senate. In fact, it is only if you look on the personal exemption and standard deduction as "basic allowances" and part of the normal tax structure, that the base broadening "reforms" assume such a large dollar proportion. Raising the personal exemption, the standard deduction and earned income credit obviously will erode the tax base, however, almost to the extent that other reforms widen it. Under the Senate measure, the net base broadening—that is, the revenue gains from reforms *less* the increases in the basic allowances—is only $76 billion for individuals over the fiscal 1987-1991 period. This pattern is likely to hold in conference.

I. Average Income Tax Liability and Tax Rate, Present Law and Proposed Legislation[1], by Income Class

Income Class ($000)	Tax Liability: Present Law 1987 Income Level	Tax Liability: House Bill 1987 Income Level	Tax Liability: Senate Bill 1986 $ 1988 Income Level	Average Tax Rate: Present Law 1987 Income Level	Average Tax Rate: House Bill 1987 Income Level	Average Tax Rate: Senate Bill 1986 $ 1988 Income Level
0-10	$ 68	$ 16	$ 13	1.4	0.3	0.3
10-20	886	678	617	5.8	4.4	4.2
20-30	2,168	1,954	1,766	8.3	7.5	7.0
30-40	3,346	3,045	2,802	9.3	8.5	8.1
40-50	5,100	4,658	4,184	11.0	10.1	9.4
50-75	8,166	7,563	7,289	13.2	12.2	12.2
75-100	14,223	13,407	12,951	16.0	15.1	15.2
100-200	28,245	26,196	24,405	19.8	18.4	18.2
Over 200	136,714	128,711	118,306	23.5	22.1	21.2
All	$ 3,210	$ 2,919	$ 3,132	11.3	10.5	10.6

[1] Some provisions not distributed by income class.
Sources: "The President's Tax Proposals for Fairness, Simplicity and Economic Growth," May 1985; Ways and Means Committee Report on H.R. 3838, Dec. 7, 1985; Senate Finance Committee Report on H.R. 3838, May 29, 1986.

II. Base Broadening of Individual Income Tax Structure Under Senate Tax Reform Bill[1] FY 1987-1991

Provision	Revenue Impact $bils.
Tax shelter and interest expense deduction limits	62.2
Retirement income and employee benefits provisions	35.7
Depreciation changes and ITC repeal (individual only)	26.6
Second-earner deduction repeal	26.2
Limitations on employee business expense deductions and miscellaneous itemized deductions	22.9
Sales tax deduction repeal	17.5
Medical expense floor increase	9.6
Income averaging repeal	8.8
Alternative minimum tax	6.5
Limitations on business meal, travel, and entertainment expense deductions	5.1
Trusts and estates provisions	4.5
Accounting provisions (individual only)	3.7
Taxation of all unemployment compensation	3.2
Dividend exclusion repeal	2.9
	235.4
All other individual revenue raising	24.7
Total individual revenue raising	260.1
Rate reductions[2]	-175.8
Personal exemption and standard deduction increase and other adjustments	-184.3
Net effect on individuals	-100.00

[1] Before any Senate floor amendments.
[2] Includes effect of change in treatment of capital gains
Source: Senate Finance Committee Report on H.R. 3838, May 29, 1986.

Business Provisions

Despite the still very significant shift in tax burdens from individuals to the corporate sector under the bill, most busi-

*The statistics on higher tax payments and higher shares paid by the top income groups suggest that this taxpayer response has occurred in spite of the more publicized expansion of tax shelter activities, particularly in the real estate area, following some provisions of ERTA.

ness groups found themselves supporting the Senate measure, some quite actively. Others viewed it simply as the lesser of the evils compared to the House version.

From a business viewpoint, the Senate measure clearly is preferable in the capital recovery area. In fact, in some respects the Senate's modified Accelerated Capital Recovery System (ACRS) offers more generous depreciation than present law—with the most notable exception of real estate. Proposed repeal of the investment tax credit, however, continues to pose a large negative for capital investment objectives. The relatively harsh transition rules for most businesses and partial loss of carryovers are serious problems, too. Accounting changes and capitalization requirements under the Senate measure suggest new burdens comparable to the House bill. In the pension area, the Senate would make much more extensive changes than the House, some of which could involve substantial employer costs—vesting and coverage requirements, in particular. And there is the specter of the corporate alternative minimum tax, estimated to raise $33 billion or a third of the net corporate income tax increase under the bill, and to introduce the major uncertainty of a book income tax base into the system (see *Federal Tax Policy Memo*, May 1986).

The extent of gross tax base broadening under the corporate provisions is almost as great as in the individual sector as shown below in Table III:

III. Base Broadening of Corporate Income Tax Structure Under Senate Tax Reform Bill Fiscal Years 1987-1991

Provision	Revenue Impact $bils.
ITC repeal	130.9
Accounting provisions	50.0
Alternative minimum tax	33.3
Insurance provisions	6.0
Foreign tax provisions	4.3
	224.5
All other corporate revenue raising	30.5
Total corporate revenue raising	255.0
Rate reductions	-128.0
Other adjustments	-26.6
Net effect on corporations	100.4

Source: Senate Finance Committee Report on H.R. 3838, May 29, 1986.

As indicated, the proposed corporate rate reduction to 33 percent with lower graduated rates below $75,000 of taxable income would offset about half of the base broadening, with other adjustments leaving the net increase on the corporate sector over five years at $100 billion. The rate reduction obviously is critical for business support of the Senate bill, and any backtracking here to pay for individual tax provisions would not only erode business support but cast more doubt on the already uncertain economic impact of the reform movement.

One question that really has not been raised is the implication of a lower maximum individual rate, basically 27 percent, than the corporate rate at 33 percent. In years past, Treasury always worried about corporate rates significantly lower than the top individual rates and the resulting spur to set up closely held and professional corporations to avoid the high individual rates. Little consideration has been given to the reverse situation.

It's difficult to contemplate any real movement among middle-size and large businesses to "disincorporate" on the basis of a potential 6 percentage point differential between top corporate and individual rates. But it could be of real significance for those at the margin of decision whether to operate in partnership, proprietorship, or particularly in Subchapter S form, as opposed to regular incorporation. It also may bring into sharper focus the existing double taxation of corporate income, once at the corporate level and again at the shareholder level—something the Senate bill does not address at all. The House measure at least made a gesture toward reducing the discrimination against the corporate form, but it's apparent that broad support for any particular form of dividend tax relief is still lacking.

Outlook

Tax reform 1986-style would have some very identifiable long-term consequences. ***One would be a bonanza for the states with income taxes, particularly the majority tied to the Federal base but not to the Federal personal exemption level. The extent of gross base broadening, both individual and corporate, is so significant that many states will feel extreme pressure to reduce their own income tax rates and increase exemption levels.*** But not necessarily in a revenue neutral mode. Some will want to use part of the gravy for increased funding of state/local expenditure programs, which, incidentally, would accord with the President's view on Federalism and the campaign to pinch back Federal grants and domestic programs. Obviously, it would be a lot easier for the states to do this when the Federal government, in effect, is handing over increased tax capacity.

For Federal fiscal policy, tax reform still would leave a lot of unanswered questions. There is no assurance that over time paper revenue neutrality will hold. A good argument can be made that, with extensive changes in taxpayer behavior, a significant part of the broadened base will erode. On the other side, it could be argued that the lower rates and presumably better "horizontal" tax burden distribution—more people in each income group paying more equal amounts of tax—will lead to significant compliance improvement. It can be argued, in fact, that there has not been a real test of this approach to compliance until now. These factors may offset each other.

What if, with continuing budget deficits, Congress decides to raise net revenues after all, as many assume it will do, at least for fiscal 1988 and afterwards? The tax reformers will say that with a more equitable base, income tax rates can be raised more easily. We would not bet on that. More likely, the big reform of 1986 will be viewed by the public as a* commitment *to lower rates, not an experiment subject to whims of fiscal policy, and that any move to undo this commitment, at least in the next three or four years, will not be tolerated. In broad policy terms then, this may well be, in Horace Busby's words, "the last dance with the income tax." We are not suggesting for a moment that there will not be further income tax changes, starting with yet another technical corrections bill. But, for future revenue requirements of any real size, we may at last have to turn to a broad-based Federal consumption tax—inevitably, the subject of much continuing debate in the future.

(SPENDING DOUBLES, from page 1)

spending until the mid-1930s. World War II developments catapulted that share to over 90 percent during the peak spending years.

States and localities will spend $628 billion this year from the funds they raise. (Expenditures from Federal grants-in-aid to these units are counted in the Federal total.) This will represent an increase of about $59 billion over the previous fiscal year, as compared to the rise in Federal outlays that is estimated at $36 billion.

Measured on a somewhat different basis (within the framework of the national income and product accounts), government spending since 1950 has grown far more rapidly than the economy at large. In calendar year 1950 government spending was equal to 21.3 percent of gross national product (GNP). It grew to 26.6 percent of GNP in 1960, to 31.3 percent in 1970, to 32.6 percent in 1980, and now stands at about 35 percent of GNP, according to Tax Foundation estimates.

The second table on page 4 provides further details.

(Continued on page 4)

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(TAX BURDENS, from page 1)

crease of 31.9 percent from 1979.

During the same five-year period there was a sharp increase in the number of persons with adjusted gross incomes of $1,000,000 or more. There were 16,662 taxpayers in this top group in 1984, up nearly five times from 3,601 in 1979. They paid an average 1984 tax of $910,294 (almost 50 percent of taxable income).

The table on page 1 provides details.

THE FRONT BURNER

By Robert C. Brown, President
Tax Foundation

"Bottom-Line Tax Policy"

A new style of tax legislation has surfaced in recent years—bottom-line tax policy. Sound principles of public finance don't matter so much. What counts is how close the tax writers can come to a predetermined bottom-line revenue target. These shenanigans started with TEFRA in 1982. They lurk in the bill now in the Senate/House Conference Committee.

There will undoubtedly be much to praise in what emerges as the final bill. However, the tax reform act of 1986 will not be an unmitigated boon. The bill harbors many unforeseen negative effects that will have to be dealt with in later years.

One item—treatment of retirement benefits for those in contributory pension plans—will have much more immediate consequences. Current law allows those who retire with such pensions to draw, tax-free, benefits for up to three years until the money they have paid into their pension funds and on which they have already paid taxes is fully drawn down. The new law would prorate the drawdown over the estimated actuarial life of the pensioner.

What's the big deal? Well, in the long run, the change affects some 20 million U.S. workers—mostly Federal, state, and local government employees, but many private-sector employees, too. In the short run, it directly impacts between 250,000 and 300,000 Federal employees who are eligible to retire now. In effect, it delays recovery of contributions which have already been taxed. It also knocks into a cocked hat financial planning these employees have done for their retirement. All in the cause of plugging some $5 billion in revenue into the tax bill.

Good. It will weed out the bureaucratic deadbeats and make room for younger, more energetic workers. Wrong. It could drive out the most experienced, most senior career civil servants from just about every government agency who will want to retire before the deadline for the new treatment. Officials at the IRS, NASA, FBI, and CIA, to mention just a few, predict a mass exodus that may seriously curtail their mission. All in the name of $5 billion.

Given the momentum behind the freight-train of "tax reform" in an election year, we realize that decrying this injustice is accepting the role of "a voice crying in the wilderness." Nonetheless, some things have to be condemned just because they're wrong. This is one. We're glad we spoke up.

(PUBLIC SPENDING, from page 2)

During the 1960s and 1970s, the social welfare programs saw a major increase in the proportion of spending being devoted to them, rising from 20.6 cents per dollar of spending in 1960 to 33.6 cents in 1980. By contrast, national defense and international relations spending fell to only 15.6 cents per dollar in 1980 from the 1960 level of 32.3 cents. Although data for the early 1980s show a modest (1.8 cents-per-dollar) increase in the spending share for defense, this outlay category pales by comparison with growth in social spending for the last quarter century. Spending on social programs in 1984 came to 15 times what it had been in 1960, whereas all other programs combined, including defense, increased by just 8 times over the same period.

Another notable recent trend has been a relative decline in education spending, which rose to 16.7 cents per dollar of spending in 1970, but by 1984 had fallen back almost to its 1960 level (13.2 cents in 1984 compared to 12.8 cents in 1960).

Interest payments on government debt consumed 9.7 cents per dollar spent in 1984, compared to a smaller 7.9 cent bite in 1980 and 6.2 cents in 1960. Debt-related outlays have been the fastest growing cost to government in recent years.

The four largest spending categories—major social programs, defense and international relations, education, and interest—accounted for more than $1 trillion, or 73.2 cents of every dollar of Federal, state, and local expenditure in 1984.

The table at the top of this page provides further details.

How Federal, State, and Local Governments Spend Each Dollar of Public Funds

Selected Fiscal Years 1960-1984

Function	Cents per dollar of total spending			
	1960	1970	1980	1984
Major social welfare programs, total	20.6	25.8	33.6	32.9
Social security (OASDHI)	7.1	10.8	15.6	16.4
Social services and income maintenance[a]	8.5	10.7	13.0	11.8
Government employee retirement	1.4	1.9	3.0	3.1
Veterans (not elsewhere classified)	2.5	1.6	1.3	1.2
Railroad retirement	.6	.5	.5	.4
National defense and international relations	32.3	25.3	15.6	17.4
Education	12.8	16.7	15.0	13.2
Interest on general debt	6.2	5.5	7.9	9.7
Environment and housing	5.4	4.4	4.9	5.8
Utilities and liquor stores	3.4	2.8	3.8	3.9
Transportation	7.6	6.2	4.4	3.5
Public Safety	1.8	2.0	2.3	2.3
Government administration	1.8	1.9	2.2	2.1
Postal service (Federal)	2.5	2.3	1.9	1.9
Sanitation	1.1	1.0	1.4	1.1
All other	4.5	6.1	7.0	6.2
Exhibit (billions):				
Total spending	$151.3	$333.0	$958.7	$1,428.0

[a] Includes public welfare, hospitals, health, and unemployment insurance benefits.
Source: Department of Commerce, Bureau of the Census; and Tax Foundation computations.

(SPENDING DOUBLES, from page 3)

Federal, State, and Local Government Expenditures[a]

Selected Fiscal Years 1950-1986

Fiscal year	Amount (billions)			Total expenditures	
	All governments	Federal	State and local	Per household	Per capita
1950	$ 70.3	$ 44.8	$ 25.5	$ 1,614	$ 466
1960	151.3	97.3	54.0	2,866	847
1965	205.7	130.1	75.6	3,581	1,067
1970	333.0	208.2	124.8	5,252	1,643
1975	560.1	340.5	219.6	7,875	2,612
1980	958.6	615.4	343.2	11,867	4,243
1981	1,109.8	717.4	392.4	13,474	4,857
1982	1,233.5	794.7	438.8	14,768	5,345
1983	1,351.0	872.5	478.5	16,099	5,798
1984	1,428.0	926.5	501.6	16,720	6,056
1985[b]	1,590.3	1,021.1	569.2	18,324	6,682
1986[b]	1,685.7	1,057.3	628.4	19,145	7,017

[a] Grants-in-aid are counted as expenditures of the first disbursing unit.
[b] Estimated by Tax Foundation.
Source: Basic data from U.S. Department of Commerce, Bureau of the Census; computations by Tax Foundation.

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TAX FOUNDATION'S VOL. 30, NO. 7 AUGUST 1986

TAX·FEATURES

U.S. Family's Purchasing Power Climbs for Fifth Year in a Row

The U.S. family's purchasing power has increased for five consecutive years, thanks to the Economic Recovery Tax Act of 1981 and a slowing in the rate of inflation, according to Tax Foundation researchers. Even so, the prototypical family—one earner, employed full-time, year-round, married, with two dependent children—has $986 less purchasing power today than ten years ago, say economists at the Washington-based tax watchdog organization.

Measured in constant 1986 dollars, the family's real income after direct Federal taxes has gone up by $2,186 or 10 percent in the last five years. But during the previous five years, the family's purchasing power actually declined by $3,172 in 1986 dollars.

During 1976-81, inflation and rising Federal taxes slashed 13 percent from the buying power of this prototypical family. During these years, increases in Federal income and social security taxes for this family averaged just over 10 percent annually, and inflation also was climbing at a rate of almost 10 percent. For the same period, this worker's pretax nominal income was rising by 7 percent annually.

In contrast, since 1981, this family's Federal direct taxes have risen by 6 percent annually, and consumer

(Continued on page 3)

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Median Family Incomes Before and After Direct Federal Taxes and Inflation 1976 - 1986

Year	Median family income[a]	Direct Federal taxes: Income tax[b]	Direct Federal taxes: Social security	Direct Federal taxes: Total	After-tax income: Current dollars	After-tax income: 1986 dollars[c]
1976	$15,016	$1,388	$ 878	$2,266	$12,750	$24,709
1977	15,949	1,466	933	2,399	13,550	24,636
1978	17,318	1,717	1,048	2,765	14,553	24,583
1979	19,048	1,881	1,168	3,049	15,999	24,315
1980	20,586	2,143	1,262	3,405	17,181	23,000
1981	21,462	2,267	1,427	3,694	17,768	21,537
1982	23,036	2,342	1,543	3,885	19,151	21,887
1983	23,943	2,277	1,604	3,881	20,062	22,217
1984	25,415	2,395	1,703	4,098	21,317	22,630
1985[d]	26,940	2,575	1,899	4,474	22,466	23,042
1986[d]	28,556	2,791	2,042	4,833	23,723	23,723

[a]Median income for all families with one earner employed full-time, year-round.
[b]Married couple filing joint return, two dependent children.
[c]Adjusted by Consumer Price Index of the Bureau of Labor Statistics. Assumes 2.5% inflation in 1986.
[d]Estimated by Tax Foundation.
Source: U.S. Department of Commerce, Bureau of the Census; U.S. Department of Labor, Bureau of Labor Statistics; Treasury Department, Internal Revenue Service.

OECD Nations Use Variety of Approaches to Taxation

Despite numerous economic and political ties, member nations of the Organization for Economic Cooperation and Development (OECD) display great disparity in how they structure their respective tax systems.

In 1983 (latest reported), the share of revenue raised by individual and corporate income taxes ranged from less than 20 percent in France and Greece to 66 percent in New Zealand, 55 percent in Turkey and Denmark, and 53 percent in Australia. Nations which collect either a very small part of their revenues from social security taxes or none at all tend to derive a large share of their revenues from taxes on income.

Income taxes furnish about 39 percent of tax revenues in the 23 OECD countries combined. The U.S. share—43 percent—ranks ninth highest.

France and Greece raised the least through individual income taxes—both at 13 percent in 1983. By contrast, New Zealand derived 60 percent of its tax collections from this source. Denmark also raised more than half of its revenues from individual income taxes. The United States, ranked seventh among the member countries, raised 37 percent of all revenues through the personal income tax.

Corporate profits tax levies also generate significant public revenue for most of the member countries. Japan raised nearly one-fifth of its 1983 receipts by taxing corporate incomes, ranking highest among the OECD nations. Six percent of total tax receipts were derived from corporate income taxes in the United States in 1983, close to the OECD average of 7 percent. At the low end, Denmark raised just under 3 percent of its revenue by taxing corporate income.

Taxes on goods and services (sales or consumption levies) are second to income taxes as revenue-raisers in the OECD countries. They provide an average of 30 percent of tax revenues. Governments in the United States raise just 18 percent of total receipts from such taxes, placing the U.S. 22nd among the 23 OECD members in terms of reliance on consumption taxes. France, Germany, and the United Kingdom all collected in the range of 25 to 30 percent of total tax receipts from consumption taxes.

Social security levies follow income and consumption taxes as the third largest revenue source for OECD countries, providing about 24 percent of all tax re-

(Continued on page 4)

43 States + DC Report Increases In Public Jobs

After a period of slowing in the early 1980s, state and local employment moved up by 2.4 percent in October 1984 (latest reported) to a level of more than 11.1 million. That represented an increase of 258,000 (full-time equivalent) employees over October 1983 levels. Higher employment was reported in 43 states and the District of Columbia.

The 1984 job gain followed a modest rise (0.5 percent) in 1983, and slight reductions in the two previous years. The declines in 1981 and 1982 marked the first reductions in state-local employment since World War II.

More than 60 percent of the 1984 increase was in the field of public education, where 158,000 employees were added. This 3.0 percent increase was the largest in over a decade. As of October 1984, there were 5.4 million public employees in the field of education, about 48 percent of all state-local workers.

Monthly payroll costs for state-local governments reached $19.8 billion in October 1984, up $1.6 billion or 8.5 percent from 1983. Average employee pay increased by $100 a month, or 6 percent for the year.

From 1974 to 1984, state-local employment grew by a modest 13 percent, about 1 percent a year on average. This was in sharp contrast to the nearly 50 percent rise experienced from 1964 to 1974. The differential growth rate reflects shifting trends in the employment of public elementary and secondary schools. From 1964 to 1974 employees in this sector increased by 1.2 million (46 percent); from 1974 to 1984 the increase was 287,000. This 7 percent rise in school employees in the last decade coincided with a drop of 6 million school enrollees (14 percent), according to Tax Foundation analysts.

The number of jobs in state governments grew by about 20 percent from 1974 to 1984, generally paralleling the increase in private sector employment. Local non-school jobs grew by 13 percent. During the same period the nation's population grew by about 12 percent. At latest count, there were 472 state-local employees for every 10,000 members of the population at large, up from 467 ten years earlier.

The average monthly earnings of public employees approximately doubled during the decade. For the month of October 1984, state and local governments nationwide paid employees an average of $1,774, up from $893 in 1974.

The accompanying table provides a state-by-state breakdown of state and local government employment and payrolls for the month of October, 1984 and 1974.

State and Local Government Employment[a] and Payrolls Month of October, 1974 and 1984

State	Employees[a] Number (000) 1974	1984	Percent change	October payroll Amount (millions) 1974	1984	Percent change	Payroll per employee[a] 1974	1984	Percent change
TOTAL	9,852	11,143	13	$8,792	$19,767	125	$892	$1,774	99
Alabama	157	192	22	110	282	157	698	1,471	111
Alaska	25	40	60	31	117	277	1,266	2,957	134
Arizona	104	140	35	99	264	168	950	1,892	99
Arkansas	85	106	25	53	138	161	628	1,305	108
California	1,017	1,146	13	1,135	2,581	127	1,116	2,251	102
Colorado	129	153	19	110	285	159	855	1,859	117
Connecticut	127	139	9	122	265	117	959	1,905	99
Delaware	33	31	-6	25	52	108	763	1,684	121
Florida	389	488	25	328	798	143	843	1,634	94
Georgia	246	307	25	173	431	149	704	1,406	100
Hawaii	39	49	26	40	87	116	1,037	1,764	70
Idaho	40	46	15	29	70	145	718	1,530	113
Illinois	479	490	2	483	923	91	1,009	1,885	87
Indiana	219	242	11	168	385	129	767	1,591	108
Iowa	132	144	9	108	241	123	818	1,692	106
Kansas	114	128	12	83	201	141	731	1,572	115
Kentucky	137	158	15	95	231	142	696	1,459	110
Louisiana	185	235	27	125	344	175	677	1,461	116
Maine	46	52	13	34	76	126	726	1,457	101
Maryland	196	214	9	182	396	117	928	1,857	100
Massachusetts	264	256	-3	245	456	86	927	1,776	92
Michigan	430	405	-6	465	835	80	1,081	2,063	91
Minnesota	184	192	4	174	380	118	945	1,982	110
Mississippi	109	135	24	67	161	141	615	1,193	94
Missouri	205	219	7	159	335	111	776	1,526	97
Montana	39	44	13	31	75	142	796	1,704	114
Nebraska	85	91	7	64	138	117	752	1,526	103
Nevada	30	44	47	29	81	180	954	1,855	95
New Hampshire	35	42	20	26	62	136	757	1,468	94
New Jersey	319	361	13	315	674	114	985	1,870	90
New Mexico	61	80	31	44	126	186	727	1,585	118
New York	1,003	998	(b)	1,068	2,048	92	1,065	2,052	93
North Carolina	230	302	31	177	448	154	768	1,487	94
North Dakota	29	36	24	22	61	182	740	1,712	131
Ohio	431	463	7	369	783	112	857	1,691	97
Oklahoma	128	168	31	86	242	180	674	1,447	113
Oregon	116	130	12	104	233	124	895	1,794	101
Pennsylvania	466	453	-3	417	787	89	895	1,736	94
Rhode Island	41	45	10	37	84	129	891	1,878	111
South Carolina	132	164	24	89	229	158	673	1,399	108
South Dakota	31	35	6	23	49	111	701	1,396	99
Tennessee	193	217	12	135	315	134	698	1,452	108
Texas	547	781	43	407	1,272	213	743	1,628	119
Utah	59	74	25	44	123	178	751	1,654	120
Vermont	23	25	9	18	38	106	783	1,528	95
Virginia	238	277	16	186	444	138	783	1,601	105
Washington	175	205	17	168	396	136	961	1,935	101
West Virginia	82	95	16	55	135	145	675	1,418	110
Wisconsin	207	225	9	189	414	118	913	1,835	101
Wyoming	22	35	59	17	62	270	754	1,804	139
District of Columbia	55	48	-13	58	110	91	1,046	2,325	122

[a]Full-time equivalent employees.
[b]Less than .5%.
Source: U.S. Department of Commerce, Bureau of the Census, and Tax Foundation computations.

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(U.S. FAMILY, from page 1)

prices have gone up by just under 4 percent a year. The family's nominal income has increased an average of almost 6 percent annually. This means that after-tax, inflation-adjusted income for the family has risen at the rate of almost 2 percent a year since 1981, according to Foundation analysts. While social security tax growth still outpaces gains in the paycheck, the hold on inflation and income taxes is working in the family's favor.

From 1976 to 1986, while pre-tax income almost doubled, direct Federal taxes were climbing by 113 percent, from $2,266 to $4,833. Income tax liabilities went from $1,388 to $2,791, an increase of 101 percent. Social security taxes jumped from $878 to $2,042, or 133 percent. Increased revenues were needed to pay for higher benefits as a result of indexing benefits to the Consumer Price Index (CPI) and increases in the number of beneficiaries.

While the rise in direct Federal taxes reduced the family's nominal dollar income by $2,567, its gain, before taking inflation into account, was still $10,973, or 86 percent for the decade, Tax Foundation economists note. As a proportion of the family's income, direct Federal taxes ranged from a low of 15.0 percent in 1977 to a high of 17.2 percent in 1981.

For the period 1976 to 1986, the price level, as measured by the CPI, almost doubled, making each 1976 dollar worth only 52 cents in 1986. The combination of rising prices and a rising tax bite reduced the purchasing power of the family by almost 4 percent for the entire decade.

The table on page 1 provides additional details.

Tax Foundation's statistical handbook, ***Facts and Figures on Government Finance,*** 1986 edition, is now available. Purchase price is $75.00 ($65.00 members of Tax Foundation).

MARK YOUR CALENDAR

Tax Foundation's **38th National Conference** and **49th Annual Dinner** will be held this year on **Wednesday, December 3, 1986,** at the **Waldorf-Astoria Hotel** in New York City. Details will be announced in future issues of *Tax Features.*

THE FRONT BURNER

By Robert C. Brown, President Tax Foundation

"Budget Update"

"Everybody wants to dance with Rosy Scenario, because she's the best on the floor." That's what a top House Budget Committee staffer told a group of policy analysts a few weeks ago. The problem is that, sooner or later, fickle Rosy always leaves the dance with somebody else.

Tax Foundation's Shadow Committee on the Federal Budget has just released its latest look at the state of the budget. The news is anything but rosy:

- The economy remains weak, despite lower interest rates, a declining dollar, and low inflation. Short-term prospects are little or no better.
- The Supreme Court has knocked out the autopilot of the Gramm-Rudman-Hollings deficit reduction procedure. Congress must now deal with the pain of actually voting cuts.
- The White House and the Congress continue to favor budget cosmetics over substantive deficit reduction action. "It could be that taking credit for savings has become a substitute for making them," the Shadow Budget Committee lamented.
- The tax "reform" program now in the congressional conference will make it even more difficult to take any tax action in the name of deficit reduction.

What does this mean for public policy and for the fiscal health of the U.S.?

"You can't get there from here," as they say "down Maine." And we won't get there—"there" being a healthy Federal budget situation—unless we take certain steps:

1. Ban Rosy from the dance hall. Let Congress and the White House agree to take the optimistic excesses out of budget making. They serve no one—politically or fiscally.
2. Avoid the budgetary legerdemain of bookkeeping ploys, imaginary baselines, faulty cost estimates and other gimmicks that have brought us to the point, as the Committee report says, where "nobody can calculate authoritatively what has been accomplished by way of genuine deficit reduction."
3. Recognize that budgetary shenanigans are the major roadblock in the way of devising creative new solutions as this nation moves inexorably toward the twenty-first century. Until we can stop throwing away money on outmoded policies, we cannot free today's and tomorrow's creative thinkers to put in place efforts that address today's—and tomorrow's—needs.

The real tragedy about the budget mess is that it is a millstone around the neck of a country that is now ten years into its third century. It's time our elected leaders recognized that, and did something about it.

TAX FOUNDATION

(OECD COUNTRIES, from page 1)

ceipts. Variations from country to country are significant, however. Australia and New Zealand do not levy social security taxes. Denmark gets less than 4 percent of its revenue from such taxes. By contrast, social security taxes accounted for more than 40 percent of total tax revenues in France, Spain, and the Netherlands. The United States ranked in the middle range, 11th among OECD countries, getting 29 percent of its taxes from social security collections.

Property taxes generally are not a major source of tax revenue among OECD nations, providing 5 percent of total taxes on average. In 1983, the United Kingdom ranked first in its reliance on property taxes (13 percent of total), followed by the United States (11 percent) and Japan (9 percent).

Another way to compare tax systems among the major industrialized countries is to examine the size of their tax receipts in relation to economic production. The OECD measures this by gross domestic product, or GDP.

By this measure, Sweden is the "most taxing" nation, with receipts coming to just over 50 percent of GDP in 1983. The Netherlands ranks second at 47 percent. U.S. taxes in 1983 came to 29 percent of GDP, placing this country 20th among its OECD affiliates. Japan's taxes came to 28 percent of GDP. Other countries at the low end were Spain and Turkey, where taxes amounted to 27 and 19 percent of GDP, respectively.

The table below provides further details for the distribution of tax revenues in selected countries for FY83.

Distribution of Tax Revenues In Selected Countries by Source

(Percent of total taxes from each source)

Fiscal Year 1983

Country	Taxes on income and profits[a]		Social security taxes	Taxes on goods and services			Property taxes[c]	Other and unallocable[d]
	Individual income	Corporate profits		Total[b]	Consumption taxes: General	Consumption taxes: Specific		
Australia	43.94	8.77	—	33.04	7.41	20.84	8.42	5.83
Austria	22.96	2.86	31.78	32.16	20.78	10.38	2.78	7.46
Belgium	34.96	5.97	30.69	26.35	16.71	7.99	1.81	.22
Canada	35.58	7.46	13.14	32.67	11.64	14.41	9.12	2.03
Denmark	52.01	2.98	3.86	35.78	21.10	13.34	5.24	1.1
Finland	45.17	4.42	7.77	39.91	19.77	19.68	2.53	.20
France	13.41	4.29	43.89	28.96	20.51	7.70	3.73	5.72
Germany	28.26	5.14	35.69	27.52	16.99	9.37	3.38	.01
Greece	13.08	2.46	35.47	43.31	15.05	21.60	3.32	2.36
Ireland	29.47	3.79	14.91	46.05	21.07	23.30	3.84	1.94
Italy	27.91	9.34	35.87	23.40	14.92	9.86	2.83	.65
Japan	25.57	19.62	29.95	15.20	—	13.15	9.39	.27
Luxembourg	27.24	17.33	25.04	23.71	12.08	11.05	6.10	.58
Netherlands	21.34	6.09	45.00	24.12	14.79	7.15	3.18	.27
New Zealand	59.93	6.28	—	25.79	11.79	12.77	7.61	.39
Norway	25.29	14.59	21.70	36.02	18.21	16.59	1.76	.64
Portugal	(e)	(e)	25.95	43.85	14.14	27.92	1.77	28.43[e]
Spain	21.14	4.92	44.98	23.96	12.28	11.67	3.76	1.24
Sweden	38.91	3.41	26.93	24.44	13.55	9.72	1.66	4.65
Switzerland	35.61	6.01	31.23	19.37	9.33	8.54	7.77	.01
Turkey	44.46	10.87	5.32	32.97	—	32.55	5.62	.76
United Kingdom	27.70	10.84	17.66	29.75	13.86	14.16	12.66	1.39
United States	37.12	5.52	28.71	18.02	7.00	8.56	10.62	—

[a]Includes taxes on capital gains.
[b]Includes import duties, profits of public fiscal monopolies, licenses, and other business taxes.
[c]Includes taxes on movable and immovable property, net wealth taxes, and estate and gift taxes.
[d]Includes general and selective taxes on payrolls which are not earmarked for social security purposes, and other taxes not elsewhere classified.
[e]Taxes on income and profits amount to 24.69% of total taxes, but are included under "other and unallocable," as they are not segregable between individuals and corporations.
Source: Organization for Economic Cooperation and Development.

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